

IFRS news

Eurozone and 2011 financial reporting: not just about the banks

In this issue:

- 1 **Economic conditions and 2011 year ends**
- 4 **Interview**
IASB chairman Hans Hoogervorst
- 6 **IFRS quiz**
Debt versus equity
- 9 **Contacts**

Mary Dolson, partner in PwC's Global Accounting Consulting Services, provides an overview of the impact of the current economic climate on 2011 financial statements of entities outside the banking and financial services sector (guidance on issues affecting financial services entities is available in our ['practical guide'](#)).

There continue to be significant concerns about the economies of some European countries. Austerity programmes and rescue packages have not eliminated the possibility of default on sovereign debt, and the broader economic news remains gloomy.

All entities doing business in the eurozone need to consider the impact of the current economic climate on their 2011 financial statements. Entities in some industries are directly exposed to the government as a customer. Banks and other financial institutions are the most exposed to sovereign debt. Many entities in a variety of industries are exposed to macro-economic trends, such as reduced consumer spending and downward pricing pressure.

Going concern

The current environment might result in reduced availability of credit and declining business performance. Financial institutions might impose stringent requirements over new or existing borrowings. This could cast doubt on the going concern assumption.

Conditions or events that might cast doubt on the going concern assumption include:

- squeezed financing and indications of withdrawal of financial support by lenders;

- adverse key financial ratios; and
- significant deterioration in the value of non-financial assets.

You should assess the appropriateness of the going concern assumption and disclose any material uncertainties.

Accounts receivable and revenue recognition

Many entities continue to do business with governments in the troubled eurozone countries, despite long delays in payment, mandatory restructuring of older unpaid debtors, significant discounts on factoring receivables where factoring is possible and downward pricing pressure on goods and services. If these are your circumstances, you should consider what issues might arise around the valuation of accounts receivable and recognising revenue.

Valuation of new and outstanding trade receivables

You should also consider for impairment all existing and new trade receivables from governmental bodies in troubled eurozone countries. An impairment loss is calculated based on revised expected cash flows, discounted at the receivables' original effective interest rate. Any impairment

charge is recorded as a current-period bad-debt expense.

You should consider discounting, on initial recognition, any receivables that are not expected to be collected immediately. There is no 'grace period' in the revenue standard for receivables that are collected within one year or any other specific period. You should discount accounts receivable at initial recognition, with a consequential reduction in revenue, if the effect of discounting is expected to be material.

Discounting requires estimating the date of collection and the actual amounts that will be collected, and determining an appropriate interest rate to use.

When estimating the date of collection, you should use the most recent data available on day-sales outstanding, adjusted for any recent developments.

The appropriate discount rate is the rate at which the customer could otherwise borrow on similar terms. For a government body, a reasonable starting point for estimation is the most recent rate at which the relevant government body has been able to borrow.

Some receivables may be interest-bearing by statute; however, this does not remove the requirement to consider discounting. The rate of interest that government bodies are paying is unlikely to be the same as the rate at which receivables should be discounted.

Revenue recognition

You also need to determine whether revenue should be recognised for current sales, and the amount of revenue to be recognised. You have to meet all five revenue recognition criteria in IAS 18, 'Revenue', in order to recognise revenue. The criteria that are most under stress in the current environment are that:

- revenue can be measured reliably; and
- it is probable that economic benefits will flow to the entity.

You should first determine if it is probable that you will be paid for the goods you have received. Slow payment does not, on its own, preclude revenue recognition. However, slow payment may well reduce the amount of revenue, because the corresponding receivable will be discounted.

Revenue recognised might be further reduced by an estimate of discounts, clawbacks and future allowances that governments might demand.

You should not recognise revenue if you don't expect to receive payment, or if you expect discounts and allowances to be material but cannot estimate them.

Non-financial asset impairment

Current economic difficulties will impact the expected future cash flows to be generated by long-term, non-financial assets such as goodwill, PPE and intangible assets. If your business has significant non-financial assets relating to, located in or selling into any of the troubled eurozone economies, you should consider the impact when measuring the recoverable amount of non-financial assets.

The effects of the economic downturn could impact impairment calculations in several different ways, notably: triggering impairment reviews; affecting key assumptions underlying management's cash flow forecasts (growth, discount rates); and requiring more sensitivity disclosures.

You should determine an impairment loss, if any, after calculating the recoverable amount. You also need to be alert to the use of over-optimistic assumptions in impairment cash flow models in the current environment.

Employee benefits

Long-term employee benefit liabilities, including defined benefit pension obligations, are discounted using a rate based on market yields at the balance sheet

date on high-quality corporate bonds of equivalent currency and term. The bond should be rated at least AA to be considered 'high quality'. Use market yields (at the balance sheet date) on government bonds of equivalent currency and term if there is no deep market in high-quality corporate bonds. Discount rates and other assumptions are coming under more scrutiny in the current environment.

Entities in the eurozone have a policy choice to consider discount rates either at the level of the eurozone or the individual country. You should apply the policy consistently from year to year, and any change is a change in an accounting policy. A change from a eurozone corporate bond rate to a country government bond rate is unlikely to provide more reliable and relevant information.

Many entities use actuaries to help derive appropriate assumptions; actuaries use different approaches to develop their advice. Where an actuary uses a different methodology from that used in prior periods, you should bear in mind consistency and applicability. A change in methodology should lead to a 'better' estimate of the appropriate discount rate, and should reflect available data about market yields and the benefit plan's expected cash flows.

Provisions

IAS 37, 'Provisions', requires provisions to be discounted, typically starting with a risk-free rate. The sovereign debt crisis raises the question of whether a downgraded government credit ratings means that government bond yields no longer provide a risk-free rate.

There are some countries for which all the ratings agencies have acted to downgrade government bonds. The yield on these bonds is unlikely to be a risk-free rate; you will need to make some risk adjustment to establish a risk-free rate. Judgement is needed to determine whether government bonds remain risk free.

Taxes

You should scrutinise the recoverability of deferred tax assets, particularly when current and expected future profits are adversely affected by market conditions. Deferred tax assets are recognised only to the extent it is probable that future taxable profit will be available against which the assets can be utilised.

Consider future reversals of existing deferred tax liabilities, future taxable profits and tax planning opportunities when evaluating deferred tax assets. You should give particular attention to the assumptions underlying expected taxable profits in future periods and to the requirement to have convincing evidence of future profits when the entity has a history of losses.

Disclosures

Additional disclosures may well be required in the current economic environment; several regulators have already issued guidance about their expectations in this area. IFRS 7, 'Financial instruments: Disclosures', is particularly relevant; take care to ensure the objectives set out in the standard are met. Further disclosures are required by IAS 1, 'Presentation of financial statements'. It may be necessary to make broader disclosures about the impact of the European economic environment on your business, financial instruments, concentration of risk and future.

Subsequent events

Events may unfold quickly; you should consider carefully whether you need to reflect events occurring between the balance sheet date and the date of authorisation in the financial statements. Events are either adjusting or non-adjusting; many non-adjusting events will still require disclosure.

You can find our guidance on economic pressures in the current environment from the topic summary: [Impacts of the current market conditions](#). Click [this link](#) or visit [pwc.com/ifrs](#), 'Additional PwC guidance'.

Raising standards



Hans Hoogervorst

IASB chairman Hans Hoogervorst tells *IFRS news* about his approach to standard-setting and the challenges around the convergence agenda.

What is the IASB's overall strategy?

It's pretty simple really. Our job is to develop a single set of globally consistent financial reporting standards that deliver high-quality information to investors. At the same time, we are working with national and regional public authorities, as well as other international organisations, to encourage global adoption of these standards.

In practice, that means completing our current work programme with the US FASB to the highest possible standard. It means consulting on our future agenda and continuing to strengthen the institutional relationships between the IASB and our stakeholders.

What is the biggest challenge you face over the short term?

There are two primary challenges. The first challenge is for the IASB and the FASB to complete jointly the remaining convergence projects of revenue recognition, leasing and financial instruments. The second is to encourage the remaining major economies to come on board.

On the first challenge, we are pretty far advanced in our work to deliver improvements to the revenue recognition and leasing accounting standards. Given the importance of this work, we are re-exposing for public comment both sets of proposals. At the same time, we are conducting an unprecedented amount of outreach activities on these projects to ensure we fully understand all of the issues and, as far as possible, we have avoided any unintended consequences.

The remaining convergence project is financial instruments. I'm pretty hopeful

that we will get very close to a converged solution in many areas of the financial instruments project. It's a difficult task, as the boards have been pulled in different directions. We've each tried to respond as best we can, but this has made achieving convergence very challenging.

What are the criteria for a good accounting standard?

In my view, a good accounting standard is one that delivers high-quality, comparable information to investors, but that does so in a way that minimises the burden on preparers. The standards need to be applicable across developed and emerging economies, auditable, enforceable and not lead to diversity in practice. It's a tall order, but one that we take very seriously.

There are various ways we achieve this. We have a geographically and professionally diverse board of talented individuals. Our work benefits from a thorough, robust and comprehensive due process. We welcome broad participation in the standard-setting process, and we debate the different viewpoints in a very transparent manner. We take the time to explain what we heard, how we responded and the rationale for the decisions we have taken. And then we revisit the standard a few years after it has come into effect, just to make sure it is working as designed. That's about as much as anyone could expect.

What is the greatest obstacle to every country in the world one day reporting under IFRS? Will it happen?

Yes, I believe it will happen. The question is when and how. Global accounting standards are an inevitable consequence of globally interconnected financial markets. The greatest obstacle is political will, and

"The greatest obstacle [to every country one day reporting under IFRS] is political will"

that is largely contained through the recommendations of the G20 Leaders and others. Even in the US, support for global accounting standards is SEC policy and the policy of the US Government. However, the SEC is an independent agency and will go through its own independent decision-making process.

How do you measure an IASB chairman's success?

One of the most important things is respect for the organisation and its work. Have we sought broad input throughout the standard-setting process, given careful consideration to the issues, developed the best possible standards, made sure they can be applied around the world and sought to avoid unintended consequences?

Not everyone will like the outcome, but respect for the way we have gone about our work, as an independent standard-setter, is in my opinion the measure of our success.

What are your thoughts on the recent SEC release of the two papers on IFRS?

They are both very good assessments of the current state of play.

The first paper looks at how well IFRSs are being applied where they are required for use. The SEC staff concluded that the financial statements analysed generally complied with IFRSs, but there were inconsistencies observed – mainly due to a lack of disclosure of accounting policies and how individual standards had been applied.

Consistent application of the standards is a major challenge for standard-setters, securities regulators and market supervisors around the world. This is something that our trustees have encouraged us to look at. However, it is also important to note that this problem is not unique to IFRSs. *The Wall Street Journal* noted that the findings were similar to an earlier SEC study of Fortune 500 companies using US GAAP. The

problem of inconsistent application exists whether companies use IFRSs or US GAAP.

However, the important point is this: you can only work towards consistent application if you have one single language, and IFRS is the only candidate.

The second paper looked at the differences between IFRSs and US GAAP and contains no major surprises. The paper recognises the tremendous progress that the boards have made in bringing IFRSs and US GAAP into alignment. However, the paper also shows how quite a few differences remain, particularly in the detail.

Many of these differences are not very important. But getting rid of them through a process of convergence could take up many, many years. That is why I am even more convinced that it is not in the best interests of investors in the US or anywhere else in the world to spend another 10 years seeking to eliminate ever-smaller differences, which entail significant costs for change without much incremental benefit. That is also why the time is right for a positive decision on the incorporation of IFRSs into the US financial reporting regime.

Should the IASB abandon convergence if the SEC doesn't make a positive statement on IFRS? When would you 'call time' on the US prevarication?

Leslie Seidman, Chair of the FASB, and I agree that we should 'call time' on the convergence programme once these few remaining projects have been completed. The convergence programme has provided a very useful mechanism to improve and align IFRSs and US GAAP. However, we think that it is now time to look to the future. A positive SEC decision will see the FASB continuing to play a very active role in the development of IFRSs.

What are you enjoying most about the job?

I get to work with an enthusiastic, young, talented group of people who are

"We should 'call time' on the convergence programme once these few remaining projects have been completed"

passionate about what we do and are working hard to help the organisation achieve its goals. It is enjoyable to work in an organisation with a very strong public-interest ethic. I also enjoy the opportunity to travel to some very interesting parts of the world and meet people with involvement in the work that we do.

The technical details of the standards can be challenging, but I have found that being a relative newcomer to accounting standard-setting has helped me to offer a fresh perspective to many of our discussions.

Where will the next group of board members come from?

Board members are selected by the trustees following an international public search for candidates. The primary criterion for selection is their practical experience with IFRSs. The trustees also consider geographical criteria, and it is their objective to increase the size of the Board to 16 members by July 2012.

The trustees have just renewed the appointment of our Chinese board member Wei-Guo Zhang and Stephen Cooper from the UK for another five-year term. Paul Pacter has also agreed to stay on for a further six months, until the Trustees appoint his successor.

That leaves three appointments to cover existing and forthcoming vacancies. Elke König stepped down from the IASB at the end of December 2012 to take up an appointment as President of the German Federal Financial Supervisory Authority, while John Smith steps down this June 2011. A further board position is available due to the constitutional amendment to expand membership of the IASB to 16 members by July 2012

Quick-fire questions

Coffee or tea? Coffee

Restaurant or home cooking?

Home cooking

Balance sheet or income statement?

Income statement

IFRS quiz: debt or equity

So you think you know your debt from your equity? Test yourself against PwC's financial instruments specialist, Tina Farington, with this IFRS quiz (the first in a series) about how to classify financial instruments from the perspective of the issuer. Please note, this is not for amateurs!



Tina Farington

Classification of capital as debt or equity keeps the CFO awake at night, and getting it wrong has severe consequences for measurement. The guidance to classify such instruments is addressed in IAS 32, 'Financial instruments: Presentation'. The IASB and FASB have been working on a project to replace their respective classification models. However, the project to define debt versus equity has been placed on hold and a converged solution seems a long way off. Practitioners are going to live and breathe the current classification model for at least a few more years. So, here are a few questions to test your knowledge of the current model under IFRS.

Q1: Which statement is true in the definition of a financial liability?

- (a) The key component to the definition is that it is based on a written contract.
- (b) It includes a contractual obligation to deliver cash or other financial asset.
- (c) It includes instruments that economically obligate one entity to deliver cash or other financial asset to another entity.
- (d) It does not include instruments that can be settled only using the entity's own equity shares.

Q2: Which of the following would preclude the classification of an instrument as equity?

- (a) The entity's ability to make distributions.
- (b) The entity's history of making distributions in prior years.
- (c) Cash payments are not at the discretion of the entity.
- (d) The liquidation ranking (for example, preferred share versus ordinary share).

Q3: Which instrument would be classified as equity under IFRS?

- (a) A preferred share that is redeemable only if there is a change in control of the entity.
- (b) A warrant where the issuer can decide to settle either in cash or by delivering own shares.
- (c) A warrant giving the counterparty a right to acquire a fixed number of the entity's shares for a fixed amount of cash.
- (d) A contract where the amount of cash that will be delivered is based on changes in the market price of the entity's own equity.

Q4: A company has issued non-cumulative, non-redeemable 5% preference shares where the payment of the dividend is solely at the discretion of the board of directors. How should the instrument be classified?

- (a) As equity, because the shares are non-redeemable and dividends are solely at the issuer's discretion.
- (b) It depends on the legal form of the instrument.
- (c) As a liability, because of the stated dividend percentage and the intention of the company to pay them.
- (d) As mezzanine or 'temporary' equity, because the preference shares have characteristics of both a liability and equity.

Q5: Which of the following is the best example of a 'compound' instrument (that is, has both a liability component and an equity component) based on the facts provided?

- (a) A non-redeemable preference share that converts into a fixed number of equity shares anytime at the option of the holder.
- (b) A preference share that is redeemable for cash in 10 years and pays discretionary dividends.
- (c) A convertible bond that may be converted into a variable number of equity shares in three years and has cumulative mandatory coupon.
- (d) Not applicable – instruments should not be split into different components.

Q6: A puttable instrument is one that requires the issuer to repurchase or redeem the instrument for cash or other financial asset on exercise of the put. The 'puttables amendment' was issued in 2008. Which of the following statements is true about the amendment?

- (a) It is an exception whereby all puttable instruments may be classified as equity.
- (b) It requires the put to be accounted for as a derivative and the rest of the instrument (that is, the share) to be classified as equity.
- (c) The puttable instrument can be classified in equity if the issuer is only required to redeem the instrument based on a contingent event that is very remote.
- (d) One of the criteria for a puttable instrument to be classified in equity is that it is the most subordinate instrument.

Q7: When evaluating a bond that is convertible into equity shares, which of the following features would result in the conversion option being classified as equity?

- (a) The convertible bond is denominated in a foreign currency.
- (b) An adjustment is made to the number of shares converted that entitles the instrument holder to additional benefits over that of the shareholder.
- (c) Cash settlement alternatives at the discretion of either the issuer or the holder.

- (d) Gross physical settlement for a fixed amount of cash in exchange for a fixed amount of shares (that is, considered to be fixed for fixed).

Q8: *On 1 December 2011, an entity enters into a contract to purchase 10 million shares of its common stock after one year at C2 per share. The contract can only be settled 'gross' in shares (physical delivery) in exchange for a fixed amount of cash (C2 per share). Which statement describes the most appropriate accounting?*

- (a) Liability for the present value of the redemption amount (that is, the proceeds to be paid upon settlement), with the offsetting entry to equity.
 (b) Derivative based on the fair value of the forward contract.
 (c) Equity only.
 (d) Liability only.

Q9: *Other than financial liabilities measured at fair value through profit and*

loss, how are financial liabilities subsequently measured under IFRS?

- (a) The amount of undiscounted cash that would be required to settle the obligation at the reporting date.
 (b) Amortised cost using the effective interest rate method.
 (c) Amortised cost using the stated interest rate of the debt.
 (d) Either fair value or amortised cost at the choice of the issuer.

Q10: *Where should interest payments on a financial liability be recognised?*

- (a) Equity.
 (b) Profit or loss.
 (c) It is management's policy choice.
 (d) It depends on the facts and circumstances (for example, whether the instrument is subsequently convertible).

Answers

Question 1: B – A contractual obligation to deliver cash is a key component of the definition of a liability. Economic compulsion alone would not result in a financial liability. Furthermore, though there is a contractual obligation that forms part of the definition under IFRS, it is not required for this to be only in the form of a written contract.

Question 2: C – The entity must have discretion to avoid cash payment to be classified as equity. The entity's historical trend or ability to make distributions is not considered as part of the analysis.

Question 3: C – This warrant meets the definition of equity as it meets the 'fixed for fixed' rule (that is, the holder can exchange a fixed amount of cash for a fixed number of shares). Derivative contracts that can be settled through any method other than gross physical exchange (for example, net cash or net share settlement) fails the definition of equity in accordance with IAS 32.26, regardless of who controls the decision. Finally, simply because an event is contingent (for example, there is a

change in control), does not negate a contractual obligation.

Question 4: A – When preferred shares are non-redeemable, the appropriate classification is determined by the other rights that may attach to them under IFRS. Distributions to holders of the preferred shares that are at the discretion of the issuer would meet the definition of equity as the entity does not have a contractual obligation to pay cash. The legal form of an instrument and economic compulsion by the entity does not impact classification of the instrument.

Question 5: B – There is a concept of a compound instrument in IFRS. The preference shares are redeemable for cash at a future date, so this represents the liability component. However, the discretionary dividends until the instrument is redeemed represent an equity component.

A convertible bond to convert into a variable number of shares results in a liability with an embedded derivative; and a preference share that converts into a fixed number of shares or

otherwise non-redeemable is equity in its entirety. Finally, there is no concept of 'mezzanine' equity under IFRS.

Question 6: D – The IASB issued a very narrow amendment in 2008, whereby certain instruments that would otherwise meet the definition of a liability (because of the obligation to redeem the instrument at the option of the holder) could be classified as equity if very strict criteria are met. One of those criteria in IAS 32.16A-B is that the puttable share is the most subordinate instrument.

Question 7: D – Only instruments that are gross physically settled by exchanging a fixed amount of cash for a fixed amount of equity may be classified as equity. A foreign currency bond will result in a variable amount of cash in settlement. Furthermore: (1) cash settlement alternatives (even those at discretion of the issuer) and (2) adjustments to the conversion ratio where the rights and relative ownership of the shareholder as compared to the instrument holder are not maintained violate the fixed-for-fixed rule.

Question 8: A – The forward contract itself is equity (that is, it meets the fixed for

fixed rule), but IAS 32.23 requires that a financial liability be set up for the present value of the forward purchase price (the present value of C20m). This amount is reclassified from equity to liability. This forward is not accounted for as a typical derivative because of the explicit guidance in this area.

Question 9: B – The instrument is carried at amortised cost; the effective interest rate method is the correct method of calculating the amortised cost of a financial liability. The stated rate is not appropriate. Furthermore, all financial liabilities not classified at fair value through profit and loss at initial recognition are subsequently measured at amortised cost.

Question 10: B – IFRS guidance is clear that interest payments on a liability should be recorded in profit and loss. This is not a policy choice.

We have more guidance on these issues. A good place to start is our [topic summary on financial instruments](#). Click [this link](#) or visit pwc.com/ifrs, 'Additional PwC guidance'.

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