IFRS news

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IASB and FASB publish exposure drafts on impairment of financial instruments

Whilst the IASB and FASB are still working together on a number of projects and previously published joint proposals for impairment of financial instruments, there are now two proposals on the table for consideration. Eniko Konczol from PwC's Accounting Consulting Services looks at the proposals and the next steps.

The IASB has issued the long awaited exposure draft (ED) on impairment 'Financial Instruments: Expected Credit Losses'. Publication of the ED follows several years of joint discussions with the FASB and the issuance of an exposure draft by the FASB on the same topic in December 2012.

The IASB proposes an expected loss impairment model that is responsive to changes in credit risk. The FASB requires recognition of full time expected losses even at inception, such as when a loan is first granted.

Both models address the widespread criticisms of 'too little, too late' heard so frequently during the recent financial crisis. Most observers were hoping for a converged solution.

How did we get here?

During the financial crisis, the G20 tasked the key global accounting standard setters to work intensively toward the objective of creating a single high-quality global standard. The boards worked together to develop a converged model on impairment for financial instruments. The IASB and FASB came together and in 2011 jointly issued an exposure draft. However, the proposals were not widely supported and work continued.

Together the boards developed the so-called 'three-bucket model' with the discussions substantially finished in July 2012. However, in response to feedback received, the FASB decided to move in another direction and developed their own single-measurement model called the 'Current Expected Credit Losses' (CECL) model. A CECL model measures loss allowance at an amount that always equals full lifetime expected losses (including at initial recognition).

The IASB took a different approach to address the concerns heard during outreach. Respondents were primarily concerned about the lack of clarity around some of the terms used and cost-benefit considerations. Overall, the IASB felt there was support amongst constituents for a model that differentiates between financial instruments that have suffered a significant deterioration in credit quality since initial recognition and those that have not.

The ED issued by the IASB therefore proposes an expected loss impairment model that is responsive to changes in credit risk. It will replace the current incurred loss model in IAS 39. It is expected that impairment losses will be larger and will be recognised earlier.

The IASB model

General model

Under the proposed IASB model, an entity should recognise an impairment loss equal to the 12-month expected credit loss. If, however, the credit risk on the financial instrument has increased significantly since initial recognition, it should recognise a lifetime expected credit loss.

The 12-month expected credit loss does not only represent cash shortfalls in the 12 months after the reporting date but all cash flows that are not expected to be received over the life of the financial instrument resulting from those default events that are possible within 12 months after the reporting date.

Lifetime expected credit losses are cash shortfalls that result from all possible default events over the life of the financial instrument. When determining whether lifetime expected losses should be recognised, an entity should consider the best information available, including actual and expected changes in external market indicators, internal factors and borrower-specific information.

Expected credit losses are determined using an unbiased and probability-weighted approach, and consider time value of money.

Simplifications to the model

The IASB has included some operational simplifications in its model in response to feedback received. Where a loan is 30 days past due, there is a rebuttable presumption that lifetime expected losses should be provided. However, an entity does not recognise lifetime expected credit losses for financial instruments that are equivalent to an 'investment grade' credit rating.

A simplified model is available for trade receivables such that an entity can always measure impairment losses at an amount equal to lifetime expected losses. The use of a 'provision matrix' is allowed if appropriately adjusted to reflect current events and forecast future conditions.

The FASB has included its own simplification: a practical expedient for assets measured at FVOCI such that an entity does not have to recognise expected credit losses if fair value is at or above amortised cost and the expected credit losses on the individual asset are insignificant.

Disclosures and effective date

Unsurprisingly, the disclosures requirements are extensive. This is one thing that is consistent with the FASB model.

The effective date is not specified in either proposal. The IASB is seeking comments on the appropriate mandatory effective date for all phases of IFRS 9 while the FASB is considering various alternatives.

What next?

The IASB's comment period ends on 5 July 2013. Comments on the FASB exposure draft are due on 30 April 2013 thereby limiting the available time to compare the proposals.

General expectation is that many respondents will continue to request a converged solution. Whether this is possible for impairment remains to be seen. No doubt this is not the last article on this topic.

IC examines discount rates for employee benefits

The IC is currently debating the most recent issue arising from the financial crisis – discount rates for employee benefits. Richard Davis from PwC's Accounting Consulting Services considers the key questions, 'What is "a deep market"?' and 'How do we define "high quality"?'

Many standards require that a discount rate is used to estimate the present value of future cash flows – some quick research suggests 16 standards. Some of these do not specify the rate that should be used and the standards that do have specific guidance are frequently inconsistent with each other. This was highlighted in feedback on the agenda consultation and the IASB intends to take on a project to research this issue.

The research project has not started but the Interpretation Committee (IC) has bravely taken on the challenge for employee benefits. Fluctuation in the rate used to measure these long-term liabilities creates significant volatility in recorded balances. Today's low interest rates have increased the obligation recorded by many entities.

The IC is now in the throes of drafting proposed changes to the recently amended IAS 19. The focus is on providing more clarity around the definition of high quality and how to evaluate a deep market. The proposals are also expected to require that if government bonds are used (in the case where there is no deep market) those bonds should be high quality.

Current requirements under IAS 19
The rate used to discount post-employment benefit obligations (both funded and unfunded) shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields (at the end of the reporting period) on government bonds shall be used. The currency and term of the corporate bonds or government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations.

IC discussions

You might have thought that IAS 19 was one of the standards that is fairly clear on the discount rate that should be used.

Some people might argue about what is or is not 'high quality' or 'a deep market' but the definition has been applied for more than 14 years and most thought they understood it. So why is the IC now grappling with the issue? Blame the credit crisis!

The credit ratings of many borrowers have deteriorated and there are fewer AAA and AA rated bonds than there were 10 years ago. Late last year, with interest rates reaching ever lower levels, the IC was asked to clarify whether the reduction in the number of high quality bonds meant that the hurdle for deciding what is 'high quality' should also be lowered.

Reporting of the IC discussions to date has been carefully worded. However, the view so far can be summarised as: explicitly or implicitly, most entities have determined that high quality means one of the two highest ratings given by a recognised rating agency, and this approach should be applied consistently from period to period.

Next steps

The IC staff is working through a draft amendment that is intended to:

- tighten up the definition of high quality and confirm that it should be interpreted as one of the two highest ratings given by a recognised rating agency;

- clarify that an entity should consider all bonds in the relevant currency and not just a single country when looking at whether or not a deep market exists and at rates in that market; and

- require that even on a fall back to government bonds those bonds should be high quality.

The third point is likely to prove controversial. It might seem reasonable to argue that if there is no deep market in high quality corporate bonds, companies should base their discount rate on the highest quality government bonds available. However, it seems less reasonable to take this approach in, for example, a hyperinflationary economy where the government bond rate would be reduced to reflect the credit spread between the local government bond rate and an AA rating, while all the other assumptions reflect the local economy.

The IC is likely to continue the debate in May – so stay tuned.

IASB evaluates initial feedback on IFRS for SMEs

The IASB is in the midst of a comprehensive review of IFRS for small and medium sized entities (SMEs). Hugo van den Ende, PwC partner and member of the SMEIG, takes a look at the comment letters and provides his perspective on the implemention of IFRS for SMEs so far.

A variety of companies globally have been using IFRS for SMEs for several years. The SME standard has been available for use since July 2009 and has been widely accepted as a move in the right direction to make IFRS accessible to smaller companies. The IASB is also considering a new project to develop a reduced disclosure only standard which might be more appealing to subsidiaries of listed companies.

But right now the IASB and SMEIG are in the process of considering feedback from the comprehensive review which will give companies already using the SME standard a second change.

87 comment letters were received in response to the request for information. The SME Implementation Group (SMEIG) has been tasked with considering the responses and developing recommendations for the IASB on possible amendments to the SME Standard.

What did the respondents say?

Scope

The SME Standard is written for entities that do not have public accountability. Most continue to agree that this should be the primary audience. That said, there is wide support for removing the guidance that prohibits publicly accountable entities that use the SME standard from describing their financial statements as conforming to IFRS for SMEs. If removed, this would result in local authorities being allowed to play an important role in whether or not these entities should be permitted or required to apply the SME Standard. The SMEIG supports this approach but this is still under consideration by the board.

Consideration of new and revised IFRSs

One of the challenges with SMEs is consistency with the principles of existing IFRS standards. The IASB developed a framework for considering the impact of new IFRSs on the SME standard during its March meeting.

The IASB has decided that new and revised IFRSs will be considered individually for inclusion in the SME standard following publication. Any changes identified will only be incorporated into the SME standard in connection with the next three-yearly review.

Most members of the SMEIG supported not automatically amending the SME Standard in response to changes in full IFRS. They argue that the SME Standard is stand alone. Stability of this standard is a basic condition – in particular from the point of view of the users which are often small or medium-sized companies with less capacity to monitor changes. The SMEIG was more inclined to first assess implementation experience of new standard and then make a decision about whether to incorporate them into the SME Standard.

For the existing new standards, the SMEIG recommends incorporating revisions to IAS 19 immediately but the changes to IFRS 3 and 10 – 13 should wait until implementation experience has been assessed. These specific proposals are still under consideration by the board.

More options

Although the majority of respondents want to include more options in the SME Standard, the opponents insist that this adds complexity. Some of the options under consideration are:

- revaluation of property, plant and equipment;
- capitalisation of development costs; and
- capitalisation of borrowing costs.

Within SMEIG there is support for the revaluation of PPE as an option as it often results in more relevant information. Furthermore, it could help entities to gain access to loan financing. If this option were to be incorporated in the SME standard, a requirement to follow IAS 16 would be considered.

The SMEIG had mixed views on the capitalisation of development costs and borrowing costs. There is a slight majority in favour of permitting (but not requiring) the option to either expense or capitalise these costs.

Income taxes

The guidance on income taxes in the SME Standard is based on an old IFRS exposure draft which never became effective. This unfortunately means that the SME Standard has some of the complexity of a full IFRS but it is not consistent with full IFRSs.

The SMEIG suggests aligning the guidance with IAS12. There is insufficient support for recognising income taxes on the basis of the amounts due to or from the tax authorities. There is also a lack of support to allow discounting of deferred tax balances. Therefore it is expected that the current guidance will be replaced by something quite similar to IAS 12.

A new project

Although the SME standard can be applied by subsidiaries of listed entities, it creates complexity in consolidation process. This is because there are many differences between the SME standard and full IFRS as applied by the parent beyond just disclosure.

Therefore the IASB is considering a new project to develop a reduced disclosure framework for subsidiaries of a listed group. There is consensus amongst the SMEIG members to encourage the IASB to pursue this as they believe that there is a significant demand across the world.

What is next?

The IASB will continue to consider the recommendations of the SMEIG. The next step will be an exposure draft in the second half of 2013. The expected effective date is planned for 2015.

Cannon Street Press

IASB issues exposure draft on employee contributions

The IASB has issued an exposure draft (ED) intended to clarify the application of IAS 19, Employee Benefits (2011) (IAS 19R) to plans that require employees or third parties to contribute towards the cost of benefits.

Some pension plans require employees or third parties to make contributions to the plan. IAS 19R, which is applicable from 1 January 2013, was intended to clarify the treatment of contributions from employees or third parties. The ED aims to address concerns that the guidance in IAS 19R is open to a range of interpretations, some of which would be difficult to apply in practice.

The ED proposes amendments that would allow (but not require) many entities to continue accounting for employee contributions using their existing accounting policy if contributions are linked solely to employee service in the period in which they are paid. That is, they may continue to account for the contributions as a reduction to the cost of benefits earned in that period.

Some entities, however, will be required to apply a more complex attribution approach to spread the recognition of employee contributions over the employee's working life. It is not clear exactly how this attribution should be done and various possible approaches have been suggested.

Any pension plan that requires contributions from employees or third parties will be affected.Preparers and users of financial statements affected by these proposals should consider whether the proposals will simplify the guidance in IAS 19R and produce more decision useful information. The comment period ends on 25 July 2013.

Discussion of the Conceptual Framework continues

The IASB continues to dedicate a large portion of its public meeting to discussion of the Conceptual Framework project. This month they covered a range of issues including other comprehensive income, measurement models, the boundary between liabilities and equity and the definition of a liability. The board has not taken any formal decisions. It is focusing on topics for inclusion in the discussion paper which is expected to be issued in Q2 2013.

IASB allows for early adoption of revenue standard

The IASB amended its previous decision and agreed to permit early application of the revenue standard. It decided that early application will improve accounting for revenue in the short term and will eliminate practice issues resulting from the application of current IFRS. For further details on the latest proposals, see Practical guide 38, Boards finalise redeliberations of revenue from contracts with customers.

IASB issues Request for Information on rate regulation

The IASB issued a Request for Information (RFI) as the first step in preparation for a Discussion Paper expected to be issued later this year in connection with Rate regulated activities. The RFI asks respondents for feedback on the common features of rate regulation and the rights and obligations it creates. The deadline for responses is 30 May 2013.

IASB work plan as of 25 March 2013

There are a number of exposure drafts and standards expected to be issued over the next few months. The current IASB work plan as at 25 March 2013 is summarised below. It reflects the next major milestones for the some of the significant projects.

The board also continues to discuss narrow scope amendments to IAS 1 on going concern and IAS 41 on bearer biological assets, as well as a number of annual improvements. A final interpretation on levies is imminent.

Project	Milestone	Expected date of issue per IASB Work plan
IFRS 9 – Classification and measurement (limited amendments)	Redeliberations	To begin Q2 2013
IFRS 9 – Impairment	Exposure draft	Issued March 2013 (see page 1)
IFRS 9 – Hedge accounting	IFRS	Q2/Q3 2013
Accounting for macro hedging	Discussion paper	Q2/Q3 2013
Revenue recognition	Exposure draft	Q2 2013
Leases	Exposure draft	Q2 2013
Insurance	Exposure draft	Q2 2013
Rate regulated activities – interim IFRS	Exposure draft	Q2 2013

ASAF membership announced

The Trustees of the IFRS Foundation announced membership of a new technical advisory body, Accounting Standards Advisory Forum (ASAF). The ASAF will be chaired by the IASB and consists of other global accounting standard setters.

The launch of the ASAF is expected to formalise and streamline the board's interactions with the global community of national standard setters and regional bodies to facilitate feedback on technical issues.

The first meeting of the ASAF is scheduled for 8 and 9 April 2013.

Initial ASAF membership

South African Financial Reporting Standards Council
Accounting Standards Board of Japan
Australian Accounting Standards Board
Chinese Accounting Standards Committee
Asia Oceania Standard Setters Group
Accounting Standards Committee of Germany
European Financial Reporting Advisory Group
Spanish Accounting and Auditing Institute
United Kingdom Financial Reporting Council
Group of Latin American Standard Setters
Canadian Accounting Standards Board
United States Financial Accounting Standards Board

Know your IFRS 'ABC': E is for 'equity accounting'

Ago Vilu from PwC Accounting Consulting Services examines the tricky areas of equity accounting.

Although equity accounting has been in use for decades, it still involves many 'shades of grey'. The IASB is trying to clarify some of the controversial areas, which might mean changes to the current accounting practice. This article takes a look at some of the grey areas and recent developments.

It is worth keeping an eye on the developments, especially considering that starting from 2013 (in the EU, from 2014), equity accounting is mandatory for joint ventures with the adoption of IFRS 11.

A one-line consolidation?

IAS 28 defines the equity method as a method of accounting whereby the investment is initially recognised at cost and adjusted thereafter for the post-acquisition change in the investor's share of net assets of the investee.

IAS 28 also says that many of the procedures appropriate for equity accounting are similar to those for consolidation (as described in IAS 27/IFRS 10), and the concepts used in accounting for the acquisition of a subsidiary (as described in IFRS 3) are also applicable to the acquisition of an associate or joint venture.

Although this might suggest that equity accounting is just a one-line consolidation, it is not always appropriate to apply IFRS 10 or IFRS 3 by analogy. In fact, the IFRS world is still debating whether equity accounting is a one-line consolidation or similar to a valuation approach.

For example, for impairment testing purposes, any equity accounted investment is treated as a single asset rather than a mini-consolidated business. Furthermore, as associates and joint ventures are not part of the group, not all of the consolidation principles are applicable in the context of equity accounting.

Key message
Although IAS 28 might suggest that equity accounting is just a one-line consolidation, it is not always appropriate to apply IFRS 10 or IFRS 3 by analogy.

Cost of an investment

IAS 28 does not define the cost of an associate or joint venture. However, an IFRIC rejection in July 2009 stated that cost generally includes the purchase price and other costs directly attributable to the acquisition such as professional fees, transfer taxes and other transaction costs.

Thus, it seems appropriate to include transaction costs in the initial cost of an equity accounted investment, although IFRS 3 would require these to be expensed if related to the acquisition of businesses.

Key message
We believe that it is appropriate to include any directly attributable transaction costs in the initial cost of the associate or joint venture.

Elimination of gains and losses on transactions with an investee

IAS 28 states that gains and losses resulting from 'upstream' and 'downstream' transactions between an investor and its associate or joint venture are eliminated to the extent of the investor's interest in the investee.

Although there is no specific guidance on how the elimination should be done, we believe that in the case of downstream transactions (sales or contributions of assets from the investor to its investee) any unrealised gains should be eliminated against the carrying value of the associate.

In the case of upstream transactions (sales of assets from the investee to its investor) any unrealised gains could be eliminated either against the carrying value of the associate or against the asset transferred. The method chosen should be consistently applied.

The standards are currently unclear on whether the elimination requirement applies also to unrealised gains and losses arising on transfer of subsidiaries, joint ventures and associates. For example, if an investor would sell its 100% owned subsidiary A to its 20% owned associate B, would it need to eliminate 20% of the gain arising on the transaction?

Such scenarios will be addressed by a proposed amendment to IFRS 10 and IAS 28 (ED/2012/6). The amendment would clarify that if the assets transferred constitute a business then any gain or loss arising on the transaction is recognised in full. If the assets transferred do not constitute a business then unrealised gains and losses should be eliminated to the extent of the investor's interest in the associate or joint venture.

Key message

Unrealised gains and losses resulting from transactions between an investor and an investee should be eliminated to the extent of the investor's interest in the investee. A proposed amendment to IAS 28 would introduce an exception to this rule – if the assets transferred constitute a business, then any gain or loss should be recognised in full.

Treatment of other net asset changes of the investee

Under the equity method, the investment is initially recognised at cost and adjusted thereafter to recognise the investor's share of the profit or loss and other comprehensive income (OCI) of the investee. Also, the investment is reduced to reflect any distributions received from the investee.

However, IAS 28 is silent on how to treat other changes in the net assets of the investee in the investor's accounts. Such changes include those arising from the movements in the share capital of the investee (for example, when an investee issues shares to or buys shares from third parties), from the movements in the share based payments reserves of the investee, or from the investee's transactions with the non-controlling interest of its subsidiaries (recorded directly in equity in the books of the investee).

The IASB has recently issued an exposure draft (ED/2012/3) that suggests a simplified approach for all other net asset changes of the investee (that is, changes other than profit or loss, OCI or dividends) and requires recognition of them in the investor's equity.The proposed approach appears to be inconsistent with IAS 1 which requires that only transactions with the owners of the group can be recognised in equity.

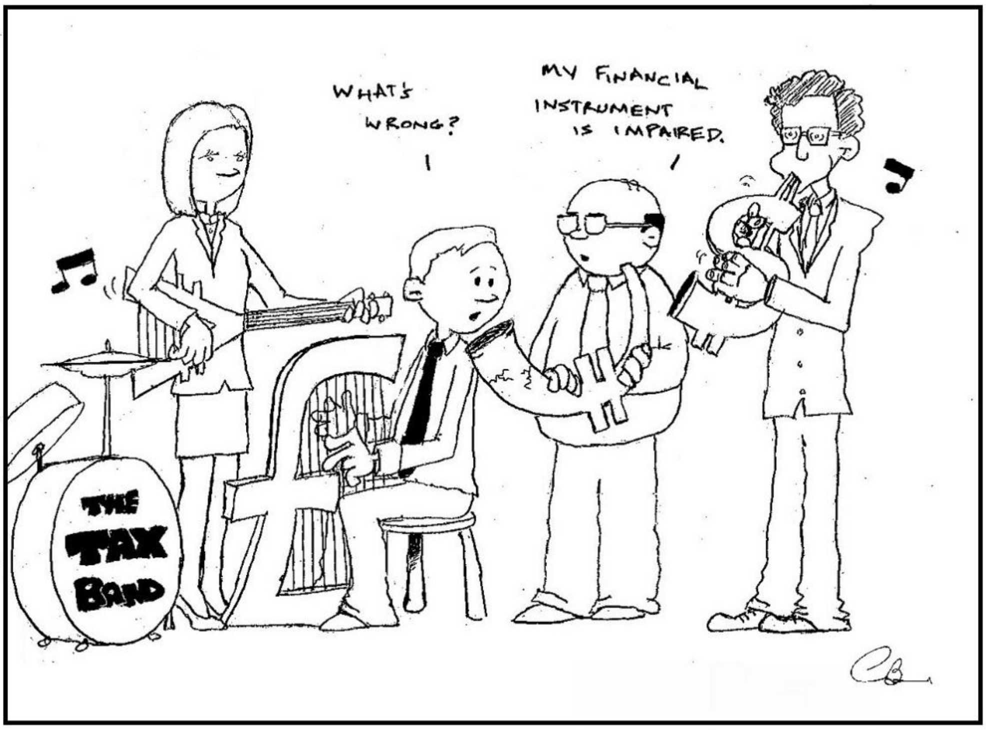
It would appear to be more appropriate to account for other net asset changes of the investee depending on their economic substance. For example, dilution of an investor's ownership interest arising from the investee's share issue to third parties is economically equivalent to a disposal of a portion of the investee. It seems appropriate to account for it in the same way as an actual disposal (by recognising any gain or loss in profit or loss).

Similarly, an increase of the investor's ownership interest of an investee that arises when an investee buys back its shares from third parties is economically equivalent to the acquisition of additional stake in the investee and it seems appropriate to account for it as such.

Key message

The standard is currently silent on how to account for other net asset changes of the investee. We suggest applying the treatment that best reflects the transaction economics and conforms to the IASB's conceptual framework. The accounting may change if the IASB issues an amendment to IAS 28 addressing this area.

The bit at the back.....



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