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IFRS news

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EFRAG and ICAS report on the needs of capital providers

The IASB discussed the implications of research on the users of financial statements performed by the European Financial Reporting Advisory Group (EFRAG) and the Institute of Chartered Accountants of Scotland (ICAS).

Have you ever asked 'how does that provide useful information?' or 'wouldn't it be more useful to account for it this way?' What is it that we mean by *useful*? Macmillan describes 'useful' as 'helpful for doing or achieving something' - but what is 'something'?

These are some of the ideas that EFRAG and ICAS explored in their paper, 'The use of information by capital providers'. The paper looks at who are the capital providers and what are their needs. The findings are clear that capital providers have diverse objectives and needs, but what does that mean for financial reporting? The IASB discussed the findings in January but no decisions were made.

The findings

The report by EFRAG and ICAS includes a comprehensive analysis of capital providers and how they use financial statements. Here is a selection of the key findings:

- Most capital providers use financial statements but in different ways. For example, professional investors rely heavily on contact with management, while retail investors are more likely to rely on intermediaries to process the financial information.
- Capital providers generally start with the income statement. Information, for example in OCI or in the notes, is at higher risk of being overlooked.
- Debt and equity providers have different needs. Debt providers are often focused on downside risk as their upside is limited.
- Decisions about stewardship sometimes require different information than valuation-related decisions.

The formal research to date is mostly from English speaking territories and the paper itself focuses on Europe. That said, many of the key findings are likely to apply more broadly.

What is next for the IASB?

Most of the findings appear to be common sense and are not 'new'. That said, the paper poses a few questions for standard setters: for example, should financial statements focus on a single type of investor or a variety of investors? How should financial reporting co-exist with other competing information services? EFRAG and ICAS also acknowledge the need for additional research.

The IASB will probably feed the discussion into its Conceptual Framework project. The comment period for the Discussion Paper on this project has recently closed and the IASB will be looking at respondents' views on a number of topics that are linked to the findings of the EFRAG and ICAS, for example, objective of financial statements and stewardship.

IFRIC 21 - just 'levies' or much more?

IFRIC 21, Levies is applicable from 1 January 2014. The interpretation was issued in 2012 but many are only just starting to understand the implications.

The title of IFRIC 21, 'Levies', implies a limited scope but the reality is quite the opposite. The interpretation captures a number of different obligations imposed by governments – some of which are not described as a 'levy'. Even more important, IFRIC 21 is an interpretation of IAS 37, so similar principles apply to other obligations in the scope of IAS 37.

IFRS 21 is effective for annual periods beginning on or after 1 January 2014. It has not been endorsed by the EU but endorsement is expected this quarter. The EU effective date is not yet available.

What does IFRIC 21 say?

IFRIC 21 clarifies that the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. If this 'activity' arises on a specific date within an accounting period, then the entire annual obligation (and possibly the related expense or debit) is recognised on that date.

While all of this sounds fairly straightforward, entities are starting to find that applying the principle can result in accounting that is surprising and counter-intuitive. This could lead to a change in the current practice for accounting for many non-income taxes across a number of jurisdictions.

What obligations are affected?

Levies in scope of IFRIC 21 include all types of payments imposed by governments other than those in exchange for goods or services, income taxes and fines or other penalties for breaches of legislation.

This captures more than one would think. For example, take property taxes. Until now, many have spread the charge evenly over an annual period. However, under IFRIC 21, the 'triggering event' could be the date when an interim or final bill is due to be paid. This might have the unusual effect of recognising expense on a specific date rather than over the period. The application of IFRIC 21 generally requires a detailed analysis of the legislation to determine when the obligation is recognised, which could be time consuming for large entities operating in multiple jurisdictions.

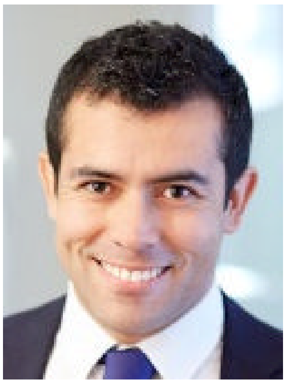
IFRIC 21 is an interpretation of IAS 37 which means that the guidance in the interpretation is consistent with the principles in IAS 37. IAS 37 provides specific recognition guidance for certain provisions (for example, restructuring provisions) but the basic principle is that a provision is recognised when there is a present obligation as a result of a past event, a probable outflow of resources and the outflow is reliably measurable. IFRIC 21 focuses on identifying whether there is a present obligation as a result of a past event and might be helpful in determining the point of recognition for provisions that are not necessarily within the scope of the interpretation itself.

What should you do?

Take one more look at payments you are making that are imposed by the government. They are likely to be addressed by the guidance in IFRIC 21. Also consider the implications on other obligations accounted for under IAS 37. Disclosures of the implications should be made in annual financial statements for 31 December 2013 in accordance with IAS 8.

Business model – should it affect accounting?

The concept of the 'business model' continues to be a hot topic. Hector Cabrera from PwC's Accounting Consulting Services looks at recent discussions.



The notion of the 'business model' has been getting significant press over the past few months. It is under consideration in the IASB's Conceptual Framework project, EFRAG has issued two papers on it, and it continues to affect standard setting including the recent projects on insurance, investment entities and leasing.

But the notion of the business model is not new. Many accounting issues require consideration of what is relevant and often one of the guiding points for relevance is the 'business model'. Also, it has already been influencing standard setting for some time (IFRS 7, IFRS 8, IFRS 9 and recent changes in IFRS 10).

The approach to financial assets with debt features in IFRS 9 is a good example, recognising that financial assets play different roles. In some cases, management's focus is on the timing of the cash flows and collectability. Fair value of the financial asset is ancillary and as a consequence, the measurement at 'cost' provides more relevant information. For other entities, the financial asset's performance drives profitability making fair value measurement more relevant.

Still, there are mixed views on how to define the business model and whether this concept should be used in standard setting. The IASB is asking this very question in its discussion paper about the Conceptual Framework. Let's look at a few of the questions underpinning the debate.

Is the concept too complex?

There are many different ideas about how to define the business model but most focus on three broad concepts: proposed value to customers, inputs and how the entity creates value.

Almost all the 'DNA' of an entity is embedded in these concepts. The first refers to the entity's product or services, the target market and its customers. The second relates to the resources and processes the entity has that make it stand out in the market. And the last one tells you how the entity makes money with the first and the second (profit formula).

These concepts are widely used among the stakeholders and the business community. Why not use them to assess relevance for the users of financial statements?

Is a single definition necessary?

The complexity of arriving at a single definition of business model should not override its potential benefits for producing relevant information. Financial statements do not need to communicate every part of the business model. For example, financial statements are not designed to provide complete information about the entity's proposed value to clients. Instead they provide limited information on inputs and certainly have a lot to say about the profit formula. Therefore, should standard setters at a minimum focus on this aspect of the business model?

What is next?

The IASB will continue the debate about whether the business model should play a more explicit and decisive role in the accounting standards in connection with development of the Conceptual Framework. There are no clear answers yet, but the possibility of introducing the business model as guiding principle for relevant financial information deserves additional attention.

Cannon Street Press

Interim standard on rate regulated activities

The IASB issued IFRS 14, 'Regulatory Deferral Accounts' (IFRS 14'), an interim standard on the accounting for certain balances that arise from rate-regulated activities (regulatory deferral accounts").

IFRS 14 is only applicable to entities that apply IFRS 1 as first-time adopters of IFRS. It permits such entities to continue to apply their previous GAAP accounting policies for the recognition, measurement, impairment and derecognition of regulatory deferral accounts upon adoption of IFRS. IFRS 14 also provides guidance on changes to accounting policies, presentation and disclosure, either on first time adoption or subsequently.

There is currently no standard that specifically addresses rate-regulated activities. The objective of the interim standard is to allow entities adopting IFRS to avoid major changes in accounting policy before completion of the broader IASB project to develop an IFRS on rate-regulated activities.

IFRS 14 is effective from 1 January 2016 and should be applied retrospectively. Early adoption is permitted. Application is not compulsory. The broader project on rate-regulated activities is ongoing. The IASB is expected to issue a discussion paper later in 2014 to seek initial views on the accounting for rate-regulated activities.

IFRS 9 Redeliberations

Impairment

The IASB continued deliberations with a focus on disclosures. Highlights of the tentative decisions are to:

- retain the requirements for a full reconciliation of the loss allowance and the gross carrying amount of financial assets (focusing on the key drivers for changes in the loss allowance);
- require disclosure of the extent to which collateral affects the expected credit loss allowance and in some cases disclose more on the calculations; and
- require disclosure of the deterioration rate for modified financial assets for which credit risk has subsequently increased significantly.

Classification & measurement

The IASB discussed clarifications and improvements on the classification and measurement ED. The Board made tentatively decided to:

- clarify that the disclosure requirements in IFRS 7 and IAS 1 are applicable for reclassifications in and out the FVOCI category;
- clarify certain relief for first time adopters, including relief from presenting comparative information in certain circumstances; and
- clarify transition requirements.

The Board will discuss the effective date of the completed version of IFRS 9 in February.

IFRS 3 post implementation request for information

The IASB has published a request for information (RFI) on experience with, and the effect of, implementing IFRS 3. The RFI is the first step in the post-implementation review of IFRS 3. The IASB aims to assess whether the standard provides useful information, what areas represent implementation challenges, and whether unexpected costs have arisen. Responses to the RFI are required by 30 May 2014.

Leasing Redeliberations

The IASB and the FASB ('the boards') held a joint meeting in January to discuss the next steps for the Leasing project. They were not asked to make decisions. The next step will be a decision making meeting in March 2014.

Lessor accounting

The staff proposed the following three approaches for classifying leases as either Type A or Type B:

- Approach 1: existing U.S. GAAP and IFRS lessor accounting;
- Approach 2: if the lease gives rise to selling profit (or loss), the lease would be classified as a Type A lease only if it transfers control of the underlying asset (that is, meets the requirements for a sale in the forthcoming revenue recognition standard). Other leases would be classified in the same manner as Approach 1;
- Approach 3: based on lessor's business model.

The boards did not express support for Approach 3 because determining the business model would be complex and requires significant judgment. Approaches 1 and 2 will be explored further.

The staff also proposed the following two approaches for accounting for Type A leases by lessors: retain the receivable and residual approach proposed in the 2013 ED or apply existing IFRS finance lease accounting.

Lessee accounting

The boards discussed the following three approaches:

- Approach 1: single approach - a lessee would account for all leases as the purchase of a ROU asset on a financed basis;
- Approach 2: dual approach - lease classification similar to the 2013 ED with targeted simplifications;
- Approach 3: dual approach - lease classification principle consistent with existing U.S. GAAP and IFRS;

A majority expressed interest in Approach 1 but no decisions were made.

Small ticket leases

The staff proposed several alternatives to provide relief in applying the leases guidance to small-ticket leases held by a lessee including:

- providing explicit materiality requirements;
- expanding the definition of short-term leases;
- applying the leases guidance at a portfolio level; or
- providing explicit scope exclusion for leases of noncore assets.

The boards will further explore all options with the exception of the exclusion of leases of noncore assets, because of the complexity involved in defining 'noncore'.

IAS 1 narrow scope amendments

The IASB discussed the transition requirements of the proposed amendments, which include application of materiality, disaggregation of line items, order of notes and presentation of items of other comprehensive income arising from equity accounted investments. They agreed that the proposed amendments should be applied retrospectively from the effective date and earlier application is permitted. The Board is satisfied with the due process requirements. An exposure draft will be published in the first quarter of 2014.

Know your IFRS 'ABC': M is for 'Money market funds'

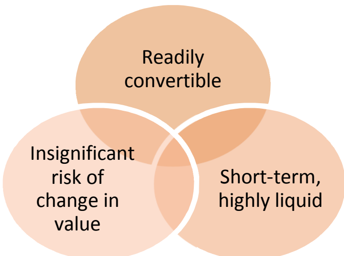
Anna Schweizer from PwC's Accounting Consulting Services Central looks at the most current challenges around defining 'cash and cash equivalents' for cash flow statement purposes.

You could ask yourself 'what is so difficult about defining "cash and cash equivalents"?' It might be easy to identify cash on hand. However, when it comes to cash equivalents, for example money market funds, the question is not always straight forward.

Let's revisit the basics and evaluate some of the challenges associated with defining cash equivalents, then look specifically at money market funds.

The basics of cash equivalents

IAS 7 defines cash equivalents as 'short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value'. The definition has three related components which should be looked at together.



Maturity

An investment requires a 'short maturity' to meet the definition of cash equivalent. IAS 7 is not definitive but it suggests this is a period of three months or less from the date of the acquisition of the investment. A longer maturity period exposes such instruments to fluctuations in capital value. The maturity period is measured from the date of acquisition, not the balance sheet date. The objective is such that the investments should be so near to cash that the only changes in value are insignificant.

Readily convertible to cash

The term 'readily convertible' implies that an investment must be convertible into cash without an undue period of notice and without incurring a significant penalty on withdrawal. Monies deposited in a bank account for an unspecified period, but which can only be withdrawn by advance notice, should be carefully evaluated to determine whether they meet the definition of cash and cash equivalents. Cancellation clauses, termination fees or usage restrictions might affect the redemption amount and create a more than insignificant risk of change in value.

Held for purpose of meeting short-term cash commitments

For a security to be regarded as cash equivalents, it should not only meet the definition in IAS 7 but also be used as a cash equivalent by the entity that holds it. That is, it should be 'held for purpose of meeting short-term cash commitments'. For example, an investing company might classify their short-term investments rather as investments than as cash equivalents.

Money market funds

Investments that could qualify as cash equivalents might include investments with financial institutions as well as short-term gilts, certificates of deposits and short-term corporate bonds.

Sometimes, instead of investing separately in such investments, an entity might choose to invest in a money market fund (MMF). A question then arises whether this investment forms part of 'cash and cash equivalents'.

An MMF is an open-ended fund that invests in a range of instruments. The main objective of such funds is to preserve principal, high liquidity and a modest incremental return over short-term interest rates or a benchmark rate.

Historically, most MMFs managed to hold a very stable asset value but during the recent financial crisis, an increasing number of MMFs "broke the buck", that is, experienced a net asset loss. This is just one reason of why MMFs need to be carefully assessed in the current economic climate.

So how do we assess MMFs?

Equity instrument or cash equivalent?

Many MMFs are equity instruments as defined by IAS 39, and therefore would generally not be cash equivalents. Some, however, might still be considered to be part of 'cash and cash equivalents' based on their substance.

If an instrument has a readily determinable market value, this is not sufficient to fulfil the criterion of being convertible to known amounts of cash. However, if the amount of cash that will be received is known with a high degree of certainty at the time of the initial investment, this can be seen as being convertible to known amounts of cash.

Possible approaches to assessing MMFs

Possible approaches to assessing whether MMFs are 'cash equivalents' include either of the following:

- *Assess whether substantially all of the MMF's investments qualify individually as cash and cash equivalents.*
  This specifically includes the maturity of the investments which individually should not exceed three months. This analysis should not only cover the assets held at the date of the evaluation, but all potential investments allowed by the investment rules set for the fund.
- *Strict fund management policies exist such that the shares themselves qualify as a cash equivalent.*
  These policies and limits are set out to fulfil the criteria set in IAS 7. Examples of such policies and limits could include a combination of:
  - controls ensuring constant net asset value or linear performance to limit volatility supported by actual performance;
  - returns benchmarked to short-term money market interest rates;
  - highest credit rating;
  - investment in high-quality instruments, typically short-term, with high liquidity and a maximum weighted average maturity of a few weeks (typically 60-90 days);
  - highly diversified portfolio; and
  - affiliation to or membership of a money market association that ensures maintenance of high standards in its code of practice.

Some MMFs put forward suggested classifications. In this case, entities should examine this assertion critically against the requirements of IAS 7 and confirm the classification at each reporting date.

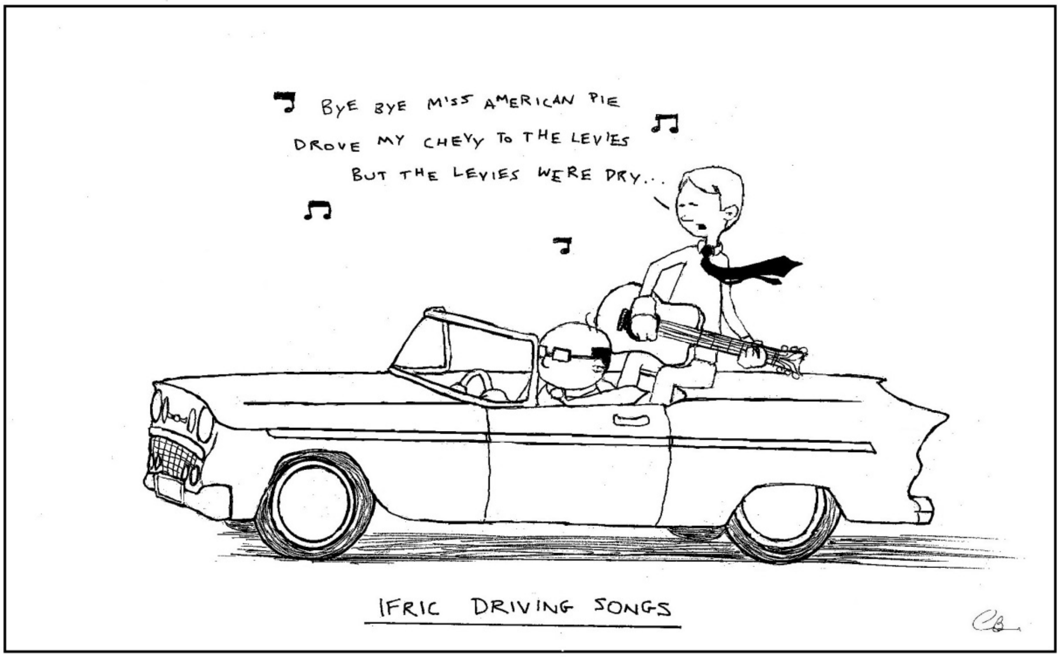
Disclosure

As the standard only provides guidance on how an entity might define cash equivalents, it is crucial to disclose the policy adopted in determining the composition of cash equivalents including any significant policy judgments.

A tricky question…

Identifying cash equivalents is not always as easy as it seems. Management should carefully assess each of its investments considering the definition included in IAS 7 as well as the purpose of holding the investments.

The bit at the back.....



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