IFRS news

In this issue:

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New hedge accounting standard is published – finally!

Almost three years after the exposure draft, the IASB published the third phase of the IFRS 9 project on hedge accounting. Gabriela Martinez from PwC's Accounting Consulting Services examines the new guidance.

The IASB published the long-awaited standard on hedge accounting in November. The changes have been widely accepted by preparers as an improvement. The new guidance provides relief from the 'rules-based' approach in IAS 39 and is likely to allow hedge accounting in more circumstances.

The 'amendments' to IFRS 9 represent the third phase of the project to replace IAS 39 as the standard on financial instruments accounting. The first phase is 'classification and measurement' and the second phase is 'impairment'.

The amendments also introduce changes to the disclosure requirements in IFRS 7.

Scope

IFRS 9 applies to all hedge accounting, with the exception of portfolio fair value hedges of interest rate risk (commonly referred to as 'fair value macro hedges'). For these, an entity may apply the hedge accounting requirements in IAS 39. This is largely because the IASB is addressing macro hedge accounting as a separate project.

Until the IASB completes its macro hedging project, entities have a choice to either apply IFRS 9 or continue to apply IAS 39 for hedge accounting. This is to allow entities not to have to change their accounting twice in the space of a few years, that is, once to move to IFRS 9 and again to move to macro hedging when that is completed. This choice is only applicable to hedge accounting; it does not apply to other aspects of IFRS 9.

Who might be interested in continuing to apply IAS 39? Most likely some financial institutions with a high volume of macro hedge accounting may continue with IAS 39. It is expected that most corporates will adopt IFRS 9 to take advantage of the positive changes it introduces.

Entities will need to comply with the new IFRS 7 disclosure requirements regardless of the standard used for hedge accounting (IAS 39 or IFRS 9).

Key proposals

There are a few changes to the accounting requirements, but they are not significant. The debits and credits and presentation in the financial statements will largely remain the same (e.g. the three types of hedges – fair value, cash flow and net investment hedges – continue to exist).

The main changes relate to the hedge effectiveness rules and to the eligibility of items as 'hedged items' and 'hedging instruments'.

IFRS 9 aligns hedge accounting with risk management practices, which is a significant improvement. IAS 39 has been criticised for its 'disconnection' from the way entities economically manage risk.

Hedge effectiveness

The amendments remove the requirement for hedge effectiveness tests to be within the range of 80%-125%. IFRS 9 does not require quantitative hedge assessments and, under certain circumstances, a qualitative assessment may be enough (for example, when the critical terms match). Even though IFRS 9 does not completely remove the need for calculations (for example, hedge ineffectiveness still needs to be recorded in the income statement) the changes to hedge effectiveness will be welcomed by many.

Hedged items

IFRS 9 allows more items to be eligible as hedged items. Let's illustrate this through some examples.

Entities can now hedge risk components in non-financial items as long as those components are separately identifiable and reliably measurable.

Example
An entity that manufactures aluminium cans can hedge its exposure to the changes in prices of aluminium arising from its inventory. Under IAS 39, it is not allowed to hedge the aluminium price exposure only, because the price of the aluminium cans is not only comprises the price of aluminium but also contains other elements (for example, other raw materials and labour costs).

Entities can now hedge aggregated exposures (that is, hedged items can also include derivatives).

Example
An entity issues a floating-rate debt denominated in foreign currency. At the time of issuance, the entity is concerned about its exposure to interest-rate risk but is not particularly concerned about its foreign currency risk. At that date, the entity enters into an interest rate swap to hedge its interest rate risk exposure; as a result, the entity has fixed its interest cash flows.

Now let's assume that, one year later, the entity becomes concerned about foreign currency risk and enters into a cross currency swap contract to hedge its foreign currency exposure arising from the same debt (which is now a fixed-rate debt as a result of the combination with the interest-rate swap). IAS 39 does not allow this designation because derivatives are not eligible hedged items.

Hedging instrument

The most significant change from hedge accounting under IAS 39 is that entities can defer the time value of options, the forward element in forward contracts and currency basis spreads in other comprehensive income (OCI). The effect is reclassified to profit or loss (P&L) at the same time the hedged item affects P&L. This change reduces volatility in the income statement.

In general, IFRS 9 is good news, and its adoption will result in more qualifying hedging relationships than under IAS 39.

Effective date and transition

Hedge accounting is to be applied prospectively (with some exceptions).

The mandatory date of application (which was previously 1 January 2015) has been 'temporarily' removed from IFRS 9. The IASB will publish the new mandatory effective date once all phases of IFRS 9 are completed (that is, when the accounting for impairment and some amendments to the classification and measurement are finalised). IFRS 9 (as currently published) is available for immediate application.

Entities can elect to apply IFRS 9 in any of the following ways:

- The own credit risk requirements for financial liabilities. IFRS 9 as amended in November allows entities to early adopt the requirement to recognise in OCI the changes in fair value arising from changes in the entity's own credit risk in financial liabilities without having to adopt any other changes.
- Classification and measurement (C&M) requirements for financial assets.
- C&M requirements for financial assets and financial liabilities.
- The full current version of IFRS 9 (that is, C&M requirements for financial assets and financial liabilities, and hedge accounting).

The transition provisions described above are likely to change once the IASB completes all phases of IFRS 9. The IASB is expected to finalise all phases of IFRS 9 during 2014 with a mandatory effective date no earlier than 1 January 2017.

The European Union has not yet endorsed any aspect of IFRS 9.

Are you ready for year-end pension accounting?

Many entities will apply IAS 19R for the first time in December 2013 year-end accounts. The revised standard was issued in 2011, but the debate did not stop there. Anna Schweizer from PwC's Accounting Consulting Services looks at the key aspects of the revised standard and the most recent developments.

The revised standard on accounting for employee benefits is mandatory for annual periods starting on or after 1 January 2013. The IASB has already issued the first amendment of IAS 19R (effective for annual periods starting on or after 1 July 2014) and the IFRS Interpretations Committee (IC) debated IAS 19 every meeting in 2013. Once you know the answers to the following questions, you will be ready.

The basic questions

Do you use a pre- or post-tax discount rate?

The IC confirmed in July that the discount rate should be a pre-tax discount rate. This is because only taxes payable on benefits or contributions in respect of past service are included in the benefit liability.

What happened to 'actuarial gains and losses' and the 'corridor method'?

'Actuarial gains and losses' were renamed 'remeasurements'. These now comprise:

- actuarial gains and losses on the defined benefit obligation;
- the difference between actual investment returns and the return implied by the net interest cost; and
- the effect of the asset ceiling.

They will continue to be recognised immediately in other comprehensive income (OCI) with no subsequent recycling to net income. The 'corridor method' is no longer allowed.

Do you still spread unvested benefits over a future-service period?

Past-service costs will now be recognised in the period a plan amendment is made.

Will there be a change in the benefit expense compared to last year?

It would depend on whether the OCI option or the corridor method was applied previously; the expense could increase or decrease.

The annual expense for a funded plan now includes net interest expense or income. This replaces the finance charge and expected return on assets under old IAS 19. The discount rate is typically lower than the expected return on assets assumption, so the income statement charge is likely to increase. However, this is offset by a movement in OCI, leading to no effect on total comprehensive income level.
If you were using the corridor method, you might see a decrease of expense because you are no longer amortising losses.

Will the presentation in the income statement and the notes be different?

Benefit cost will be split into the following categories, either in the income statement or the notes: (1) service cost; (2) past-service cost, settlements and curtailments (benefit changes); and (3) finance expense or income.

IAS 19R is likely to result in more extensive disclosure than before. The requirements include explanations about:

- the characteristics of plans,
- the amounts recognised,
- the effect on future cash flows including timing, amount and uncertainty,
- the risks specific to the entity arising from the plans,
- categories of assets based on risks / nature,
- actuarial assumptions,
- reconciliations,
- future cash flows, and
- extended disclosures for multi-employer plans.

This might seem like a long list, but the good news is that the amendment replaced the prior checklist approach, the objective being to provide relevant information when plans are material to the entity. Management will need to apply judgement when deciding what needs to be disclosed.

Can I treat expenses and taxes relating to employee benefit plans as before?

It depends on how you treated them before. The revised standard provides additional guidance on expenses and taxes. Taxes should be included either in the return on assets or in the calculation of the benefit obligation, depending on their nature. Investment management costs should be recognised as part of the return on assets. Other costs should be recognised as period costs when incurred.

Does the treatment of termination benefits stay the same?

In principle, the accounting has not changed but the definition of termination benefits was tightened, so it might capture fewer arrangements. A benefit that requires future service if it is to be earned is not a termination benefit. The liability is only recognised when the entity can no longer withdraw the offer, which might delay the recognition of voluntary termination benefits.

Were any other definitions changed?

Yes, the definition of 'settlement' was clarified. The payment of benefits provided in the terms of a plan and included in the actuarial assumptions – for example, an option at retirement for employees to take their benefit in the form of a lump sum rather than as a pension or as routine pension payments – are not settlements.

The more complex questions

Does it matter if the employer's exposure is limited and others (such as employees) help meet some of the cost?

Yes. Also, when an employer can use contributions from employees to meet a deficit, this might reduce the defined benefit obligation in some situations.

IAS 19R intended to clarify the accounting for employee contributions, but it was not until the first amendment to IAS 19R was published that the accounting became clearer. The amendment now allows contributions that are linked to service, and that do not vary with the length of employee service, to be deducted from the cost of benefits earned in the period that the service is provided. Contributions that vary according to the length of the employee service must be spread over the service period using the same attribution method applied to the benefits. Contributions that are not linked to service are reflected in the measurement of the benefit obligation.

What discount rate should I use?

The IC concluded that a project to provide more guidance around discount rates would be too broad for it to address efficiently. However, it included some helpful observations in a recent agenda decision.

The discount rate:

a) reflects the time value of money but not actuarial or investment risk;
b) does not reflect entity-specific credit risk;
c) does not reflect the risk that future experience may differ from actuarial assumptions; and
d) reflects the currency and estimated timing of benefit payments.

The IC also observed that high-quality is an absolute notion whose interpretation should be consistent over time. It should be based on international or global credit ratings, not local or national ones.

The open questions

The IASB is still working on its research project on discount rates. The IC's work in progress includes employee benefit plans with a guaranteed return on contributions or notional contributions. So we are looking forward to what the next year will bring in the area of IAS 19 and will keep you posted.

For all the IAS 19 changes in more detail, please see the 'Practical guide', the 'Straight away': 'IASB issues amendments to IAS 19R' and the 'Straight away': 'IFRS Interpretations Committee concludes on IAS 19 discount rates'.

IASB and PwC insight into IFRS developments – Meet the Experts 2013

This year's 'Meet the Experts' conference provided a forum for over 400 delegates – PwC clients, partners and staff from around the world – to learn about and discuss developments in IFRS, in the economy and in the regulatory environment.

We heard about the IASB agenda from chairman Hans Hoogervorst and Board Member Stephen Cooper; the focus of the regulators from the UK's Financial Reporting Council Chairman Richard Fleck and former SEC senior accountant and PwC partner Wayne Carnall; economic factors and trends from PwC Senior Economic Adviser Andrew Sentance; and panel discussions that included preparers and IFRS specialists from PwC.

Visit www.pwc.com/meettheexperts to read the key themes emerging from these speeches, debates and Q&As, including some of the results of our quick-fire poll questions, or if you would like to find out more about the event and how to join us next year.

Closing thoughts – 10 key reminders

A busy reporting season looms for many: we present 10 key reminders of what to consider for 2013 annual financial statements and links to where practical guidance can be found

Fair value – new disclosure requirements

Application of IFRS 13 will mean more fair value disclosure than before. IFRS 13 is effective from 1 January 2013 and requires fair value disclosure for both financial and non-financial items, regardless of whether those items are measured at fair value on a recurring or non-recurring basis. For a more detailed analysis of the new fair value disclosures required for 2013 year ends, see the IFRS 13 Practical Guide. This provides an overview of new requirements, incremental changes, where no change is expected or where IFRS 13 does not apply.

Fair value – explicitly includes own credit risk

IFRS 13 requires entities to take the risk of non-performance into account when calculating the fair value of liabilities and specifically states that this includes own credit risk. There is little guidance on how to apply adjustments for own credit risk in practice, but entities should start to develop a consistent methodology. This may include the use of CDS spreads, credit ratings, bond spreads or other financial modelling. For more guidance, see Practice Aid on credit risk and derivatives.

Fair value – interaction between unit of account and level 1 input

The interaction between unit of account and level 1 inputs has important implications when measuring the fair value of some assets and liabilities. One issue relates to valuing investments in listed subsidiaries and associates: is the unit of account the investment as a whole or is the fair value of the investment the product of the quoted price (P) fair value of shares multiplied by the quantity (Q) of shares held (PxQ)? Many believe that the IASB intended that PxQ should determine fair value even where the unit of account would not otherwise be the individual share. However, an ESMA document and questions to the IASB and IC indicate that this intent was not adequately conveyed by the written words; as a result, diversity in practice has developed. An accounting policy on unit of account, where significant, should be disclosed and applied consistently. For more guidance, see Technical Alert on P*Q.

Regulatory interest in impairment reviews

Regulators remain focused on impairment given the challenging economic environment. Groups holding significant amounts of goodwill and indefinite lived intangible assets risk challenge to their accounting and disclosures. Listed entities should pay specific attention if market capitalisation is significantly lower than the carrying value of net assets. This is an indicator of impairment under IAS 36. The challenge is to understand whether there are good underlying reasons for a spread between the two measures.

Externally imposed capital requirements, including covenants

IAS 1 requires disclosures of whether the entity complied with externally imposed capital requirements during the period and, if not, the consequences of non-compliance. The requirements include those established through contractual relationships (for example, with banks); so loan covenants are captured where loans are included in an entity's definition of capital (IFRS 7 also requires disclosure of defaults and breaches of loan covenants). This is likely to continue to receive regulator focus because it is seen as a significant area of information for users, particularly when assessing going concern considerations.

IFRS 10 – Comparative information on transition

Unlike other standards, IFRS 10 applies from the first day of the annual period in which the standard is adopted, not from the beginning of the comparative period. For entities applying IFRS 10 for 31 December 2103 year ends, the standard applies from 1 January 2013. Only where the consolidation conclusion under IFRS 10 differs from that under IAS 27/ SIC 12 at 1 January 2013 should the comparative period be restated. Where comparatives are restated, entities should present a third statement of financial position as required by IAS 1.

Disclosures for associates and JVs that also qualify as unconsolidated structured entities

IFRS 12 defines a structured entity as one that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity. It is therefore possible that an entity that has been assessed as an associate or a joint venture might also fall within the definition of a structured entity. If this is the case, management should provide information that satisfies both sets of disclosure requirements if it has interests in joint ventures or associates that are structured entities. Further guidance on IFRS 12 requirements can be found in Practical Guide, 'IFRSs 10 and 12 - Questions and Answers.

'Other' administration costs for pensions

IAS 19R requires the costs of managing plan assets to be deducted from the return on assets, which is unchanged from previous IAS 19. 'Other' administration expenses should be recognised in profit or loss when the services are received. This is a change and there is no longer a choice to include expenses in the calculation of the defined benefit obligation or in the actual and expected return on plan assets. See page 3 for more details on changes resulting from the revisions to IAS 19. Even more detail is available in the Practical Guide 'IAS 19 (revised) significantly affects the reporting of employee benefits'.

Industry-specific tariffs

Industry-specific tariffs (often referred to as 'taxes' or 'levies') continue to emerge as governments seek to increase tax revenues. The accounting will depend on the nature of the payment. The first consideration is which standard to apply. In many cases, these tariffs are not based on taxable profit and are accounted for under IAS 37 rather than IAS 12. IFRIC 21 provides guidance on when the provision should be recognised. This depends partly on the point in time at which the entity becomes obligated to pay the levy. See Straight away, IFRIC 21 'Levies' for more detail.

Supplier financing arrangements

Supplier financing arrangements raise the question of whether trade payables should be derecognised and replaced by bank borrowing. Under IAS 39, a financial liability is removed from an entity's balance sheet when it is extinguished – that is, when the obligation is discharged, cancelled or expired. Management should assess whether there has been an extinguishment of the trade payable or a significant modification of terms, resulting in a new liability to the bank.

Cannon Street Press

ED on IAS 27 amendments for separate financial statements

The proposed amendment introduces an option to use the equity method in separate financial statements. An entity can account for investments in subsidiaries, joint ventures and associates either at cost, in accordance with IFRS 9 or using the equity method in IAS 28.

The option will reduce compliance costs while providing useful information for entities that are subject to regulatory requirements to prepare separate financial statements using the equity method. The comment deadline is 3 February 2014.

IIRC integrated reporting framework

The Integrated Reporting Framework has been launched by the International Integrated Reporting Council (IIRC). This tool is intended to help businesses explain their vision and strategy for longer-term sustainability and profitability.

The Framework has the support of PwC and a range of large businesses. The IIRC's next step will be to move beyond the pilot programme and reach out more widely to businesses that are thinking about integrated reporting for the first time.

ESMA enforcement priorities

The European Securities and Markets Authority (ESMA) issued its 2013 public statement, identifying the common enforcement priorities for financial statements for the year ending 31 December 2013. They identify five priority topics:

- impairment of non-financial assets;
- measurement and disclosure of post-employment benefit obligations;
- fair value measurement and disclosure;
- disclosures of significant accounting policies, judgements and estimates; and
- financial instruments disclosures and impairment.

IFRS 9 deliberations

Impairment

The IASB continued deliberations on the impairment phase of IFRS 9. They made the following tentative decisions in their November and December meetings as they continue to address feedback from the comments letters and other outreach:

- a provision on expected credit losses (ECL) should be recognised for loan commitments and financial guarantee contracts for which there is a present contractual obligation to extend credit,
- the discount rate applicable to loan commitments is the EIR or an approximation thereof,
- for revolving facilities, ECL should be determined over the term until the Bank has the practical ability to withdraw the facility before the credit event occurs,
- no relief would be given for recognising the 12-month ECL provision for financial assets classified as at FVOCI,
- on transition, an entity may use the low credit risk exemption and the 30 days past due rebuttable presumption to determine credit risk if the information at origination is not available, and
- the expected mandatory effective date of IFRS 9 would be no earlier than annual periods beginning on or after 1 January 2017.

Deliberations will continue next month with a final standard expected in the first half of 2014.

Classification and measurement

The IASB and FASB (the Boards) jointly continued their redeliberations on classification and measurement. They made the following tentative decisions in their November and December meetings as they continue to address feedback from the comments letters and other outreach:

- the business model assessment should refer to the actual management of the financial assets in order to generate cash flows and create value for the entity, i.e. whether the likely actual cash flows will result primarily from the collection of contractual cash flows, sales proceeds or both;
- to retain the FVOCI category proposed in the ED, clarifying that it includes financial assets that are managed to achieve the business model objectives by **both** collecting contractual cash flows and selling;
- FVPL is the residual category for financial assets, but stated that financial instruments that are managed and evaluated on a FV basis must be measured at FVPL; and
- an entity may use the FV option for instruments that would be otherwise in the FVOCI if such designation eliminates an accounting mismatch, consistent with the FV option for amortised cost currently in IFRS 9.

Deliberations will continue next month with a final standard expected in the first half of 2014. The IASB noted that joint re-deliberations with the FASB have concluded. The FASB agreed to retain its embedded derivative guidance for financial assets.

Annual improvements

The IASB has released the final amendments for the 2010-2012 and 2011-2013 annual improvements project and an exposure draft for the 2012-14 cycle.

Final amendments: 2010-2012 cycle

The amendments largely apply for annual periods beginning on or after 1 July 2014.

IFRS 2, Share-based payment

The amendment clarifies the definition of a vesting condition and separately defines performance and service conditions.

IFRS 3, Business combinations

An obligation to pay contingent consideration that meets the definition of a financial instrument is classified as a financial liability or as equity on the basis of the definitions in IAS 32. Non-equity consideration is measured at fair value at each reporting date, with changes recognised in the income statement.

IFRS 8, Operating segments

The amendment requires disclosure of the judgements made by management in aggregating operating segments, and a reconciliation of segment assets to the total assets when segment assets are reported.

IFRS 13, Fair value measurement

IFRS 13's consequential amendments to IFRS 9 and IAS 39 led to a concern that entities could no longer measure short-term receivables and payables at invoice amounts where discounting is immaterial. The amendment clarifies that the Board did not intend to remove the ability to measure short-term receivables and payables at invoice amounts in such cases.

IAS 16, PPE and IAS 38, Intangible assets

Both standards are amended to clarify how the gross carrying amount and the accumulated depreciation are treated when an entity uses the revaluation model.

IAS 24, Related party disclosures

The standard is amended to include as a related party, an entity that provides key management personnel services to the reporting entity or to the parent of the reporting entity ('the management entity').

Final amendments: 2011-2013 cycle

The amendments largely apply to annual periods beginning on or after 1 July 2014.

IFRS 1, First-time adoption of IFRS

The basis for conclusions is amended to clarify that, when a new version of a standard is not yet mandatory but is available for early adoption, a first-time adopter may use either the old or the new version provided that the same standard is applied in all periods presented.

IFRS 3, Business combinations

The amendment clarifies that IFRS 3 does not apply to the formation of any joint arrangement and that the scope exemption only applies in the financial statements of the joint arrangement itself.

IFRS 13, Fair value measurement

The amendment clarifies that the portfolio exception in IFRS 13, which allows fair value measurement of a group of financial assets and liabilities on a net basis, applies to all contracts within the scope of IAS 39 or IFRS 9. It is effective from 1 July 2014 and from when IFRS 13 is first applied.

IAS 40, Investment property

The amendment clarifies that IAS 40 and IFRS 3 are not mutually exclusive. IAS 40 assists preparers to distinguish between investment property and owner-occupied property. IFRS 3 determines whether the acquisition of an investment property is a business combination. The amendment may be applied earlier than 1 July 2014 only if the information needed to apply the amendment is available for acquisitions before that date.

Exposure draft: 2012-2014 cycle

The proposed amendments are expected to apply for annual periods beginning on or after 1 January 2016. The deadline for comments is 13 March 2014.

IFRS 5, Non-current assets held for sale and discontinued operations

An asset (or disposal group) reclassified from 'held for sale' to 'held for distribution', or vice versa, is not a change to a plan of sale or distribution. The guidance on changes in a plan of sale should be applied to an asset (or disposal group) that ceases to be held for distribution but not reclassified as 'held for sale'.

IFRS 7, Financial instruments: Disclosures

Two amendments were proposed.

1. Servicing contracts – IFRS 7 requires disclosure of the extent of and risks associated with continuing involvement for assets transferred but not derecognised. The amendment provides guidance to help management determine whether the terms of servicing contracts constitute continuing involvement.
2. Interim financial statements – additional disclosure required by the amendments to IFRS 7 for offsetting is not specifically required for interim periods unless otherwise required by IAS 34.

IAS 19, Employee benefits

The amendment clarifies that the currency of the liabilities, not the country where they arise, is important when determining the discount rate.

IAS 34, Interim financial reporting

The proposal amends IAS 34 to require a cross-reference from the interim financial statements to the location of 'information disclosed elsewhere in the interim financial report'.

Know your IFRS 'ABC': L is for 'Loans'

Mercedes Baño from PwC's Accounting Consulting Services Central takes a look at the complex accounting for loans.

Sure, we all know what a loan is. But when it comes to the accounting, do we really realise the effects of the different features?

For those in banking, loans normally represent assets but thanks to double-entry accounting, they are liabilities for everyone else. A loan (in most cases) is a financial liability according to IAS 32, as it is a contractual obligation to deliver cash. Guidance on the accounting is in IAS 39.

In this article, we will concentrate on loans as liabilities and look at some common 'how to' questions on the accounting for loans.

How to determine the EIR

Most loans are initially recognised at fair value less transaction costs and then measured at amortised cost using the effective interest rate (EIR) (unless they are designated at fair value through profit or loss). The EIR exactly discounts estimated future cash payments through the loan's expected life to its initial carrying value. The EIR is also known as 'yield to maturity' or 'internal rate of return'.

When estimating cash flows, management needs to consider all of the contractual terms – for example, call options and the type of return. Determining the EIR can prove to be challenging, especially if cash flows vary throughout the life of the loan. The 'IRR' function in Excel spreadsheets comes in handy at this point.

Often the interest rate is market based (for example, based on LIBOR). Interest rate movements change the EIR and the change is recognised prospectively. The IFRS geeks call this 'applying AG7' [i].

If payments are linked to a certain index (for example, an inflation index), the guidance for embedded derivatives applies and management will need to determine if this feature is closely related to the loan. If it is, there is an accounting policy choice: either recognise changes in cash flows prospectively (as described above), or apply the guidance on changes in estimates described below.

How to account for changes in cash flows

As you might have noticed, the EIR method is not only affected by the interest rate but also by other cash flows and their expected timing (such as an inflation index that is accounted for as part of the loan), so how do we account for changes to estimated cash flows?

If the estimates of payments or receipts are revised, the carrying value of the loan should be updated by recalculating the present value of the revised estimated future cash flows at the *original* effective interest rate. The adjustment is recognised in profit or loss. The IFRS geeks call this 'applying AG8' [ii].

How to account for prepayment options

Prepayment options not separated should be considered in the estimated cash flow when determining the EIR. The likelihood and timing of the option being exercised should also be taken into account.

How to account for extension options

In this case, there are different views in practice. One view is to see this type of provision as a 'derivative' (which would not be separated if the loan is reset to the current market interest rate at the time of the extension).

[i] See the guidance in IAS 39 para AG7.
[ii] See the guidance in IAS 39 para AG8.

Others treat these options as 'loan commitments', which need to be analysed to see if they are within the scope of IAS 39. The selection of the treatment is a policy choice, to be applied consistently.

It would be useful to share an example…

If there are two bonds – one with a 5-year maturity with a prepayment option at par in year 3 (Bond A), and another with a 3-year maturity with an extension option for 2 more years at the same initial rate (Bond B) – would the accounting for both be the same?

Well….not necessarily. The prepayment option in Bond A would be considered closely related (as the exercise price would be the same as amortised cost at year 3). It would be not recognised separately.

For Bond B, the interest rate is not reset when the extension option is exercised. Under the derivative view, the option is not regarded as closely related and is required to be separated and fair valued. Alternatively, the embedded term extension option could be considered a loan commitment, and if outside IAS 39's scope, the option would not be separated.

Therefore, when applying the guidance on term-extension options and prepayments, management needs to evaluate the economics – is there a prepayment option or a term extending option? The accounting should follow…

Can it get more complicated than this?

Sure it can! What happens if management was not expecting to use the extension option but now decides that it will? The answer will depend on the policy choice that the entity made in respect of term-extending options in the first instance.

If the option is treated as a derivative and separated because it is not closely related, it would be accounted for at fair value through profit or loss. All changes in the expectation of exercise would be incorporated into the derivative's fair value, which would then be included in the loan's carrying value. Management will therefore need to update the EIR on the date of the extension to reflect the new carrying amount including the derivative.

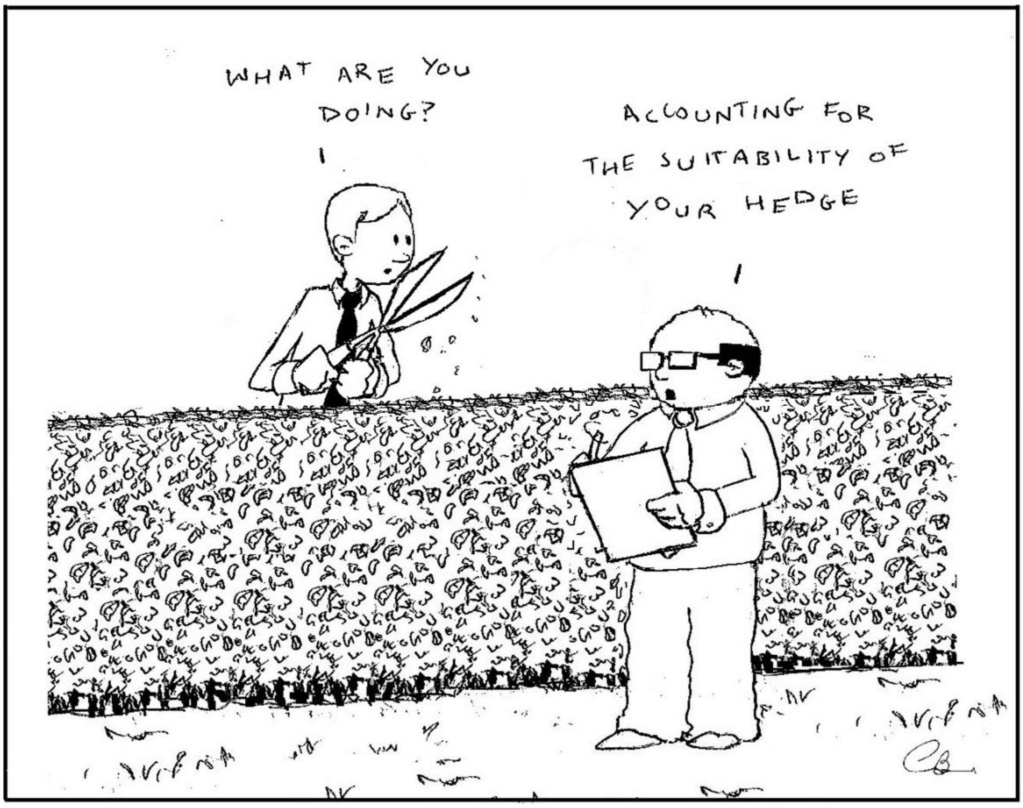
If the option is treated as a derivative but not separated because it is closely related, management can choose to follow 'AG7' and change the EIR prospectively, or 'AG8' and reflect the change in estimated cash flows during the extension period, with any difference reflected in profit and loss.

If the option is accounted for as a loan commitment, another policy choice exists. Some argue that the term-extending option is not a separate unit of account and is therefore part of the initial debt instrument, so 'AG8' adjustments should be applied. Others argue that the term-extending option is a separate unit of account (that is, a loan commitment) and therefore cash flows generated by the option should be treated as a new lending relationship.

A lot to take in…

After this 'simple' guide on how to account for loans, you might now doubt whether you in fact really understand the accounting for loans. Just remember to look at all the terms carefully and consider the 'options'. www.pwc.com/ifrs

The bit at the back.....



For further help on IFRS technical issues contact:

Business combinations and adoption of IFRS
mary.dolson@uk.pwc.com: Tel: + 44 (0) 207 804 2930
caroline.woodward@uk.pwc.com: Tel: +44 (0) 207 804 7392

Financial instruments and financial services
gail.l.tucker@uk.pwc.com: Tel: + 44 (0) 117 923 4230
jessica.taurae@uk.pwc.com: Tel: + 44 (0) 207 212 5700
tina.farington@uk.pwc.com: Tel: + 44 (0) 207 212 2826

Liabilities, revenue recognition and other areas
tony.m.debell@uk.pwc.com: Tel: +44 (0) 207 213 5336
richard.davis@uk.pwc.com: Tel: +44 (0) 207 212 3238
a.allocco@uk.pwc.com: Tel: +44 (0) 207 212 3722

IFRS news editor
Andrea Allocco
a.allocco@uk.pwc.com: Tel: +44 (0) 207 212 3722