



# *IFRS news*

## *In this issue:*

- 1 Alternative Performance measures**  
Time for ground rules
- 3 IFRIC activity**  
The 'NIFRIC'
- 5 Spotlight on IASB**  
Interview with Amaro Gomes
- 8 Cannon Street Press**  
IAS 27 narrow scope amendment  
Exposure draft on IAS 12 narrow scope amendment  
IASB Workplan
- 9 Questions and answers**  
'S' is for service concession arrangements
- 11 The bit at the back...**

## *Alternative performance measures – time for ground rules?*

**Jen Sisson looks at the latest hot topic in financial reporting – alternative performance measures.**

Everyone seems to be talking about adjusted performance measures. While APMs are not new, we have seen a significant increase in activity from regulators as they consult on making these measures more useful and reliable for users of financial reporting.

APMs have been popular with management teams for many years. They believe that APMs can offer helpful information when telling the story of their company's performance. But do investors and analysts agree? And what information exactly are they after?

### *Establishing 'ground rules'*

Generally accepted accounting principles (GAAP) such as IFRS are accepted as the bedrock of corporate reporting. But these principles may not always be adequate for explaining performance. Management teams commonly identify measures of performance in addition to the required GAAP-based earnings figures to tell their story of business performance.

Everyone has their own perspective but most investment professionals agree that having a list of 'ground rules' seems like

common sense. Some companies already follow these best practices – why isn't everyone else?

### *Reaction from regulators and others*

European Securities and Markets Authority (ESMA) is consulting on new guidelines for APM reporting. In South Africa, the Johannesburg Stock Exchange requires companies to disclose a specifically-defined APM – headline earnings per share. The US Securities and Exchange Commission sets out rules on how these types of measures can be disclosed.

The press has also caught on, particularly looking at the effect on executive and director remuneration which is also being scrutinised.

Earlier this year, Standard & Poor's published research on the 'underlying earnings' reported by the largest public companies in the UK (that is, FTSE100) over the last four years. Some of the headlines were:



- Adjusted operating profit exceeded the unadjusted operating profit in 73% of cases;
- 43 companies presented adjusted operating profit that was higher than IFRS operating profit in every one of the four years.

The S&P report also suggests that, in some cases, the use of these non-GAAP or APMs can be misleading.

#### *The emerging message from investors*

All of this discussion and debate prompted PwC to conduct a global survey of investment professionals. A clear message emerged - investment professionals think APMs are useful, but they need transparency to overcome their concerns about the balance and reliability of these numbers. Regulators appear ready to step in to ensure investors get what they need.

The survey asked 85 investors and analysts from around the world for their views on the disclosure of APMs. The report is the first in a new series of investor-focused research aimed at maximising the effectiveness of corporate reporting.

So, if adjusted performance measures are really useful to investment professionals, could their value be increased by changing the way they are disclosed? What we heard from the investment professionals was unambiguous.

#### *Key messages from investor survey*

- 95% of investment professionals would like management teams to provide clearer descriptions of the items they have adjusted when calculating their 'underlying performance' measure, as well as why they thought it appropriate to make the adjustments.

- Investment professionals are sceptical about the balance that management teams display in reporting APMs. This is a concern because a lack of balance in APM reporting could damage management's credibility with investment professionals.
- 81% of investment professionals say that if management's adjustments to GAAP numbers seem aggressive or unusual, their evaluation of the riskiness of management increases. The lack of balance may be a case for considering assurance of APMs where not already obtained.
- Only 22% of investment professionals think that the measures that move markets (including APMs) are sufficiently reliable.
- Investment professionals would find it helpful to know that companies were applying some basic 'ground rules' in their APM reporting. This would give them greater comfort in the relevance and reliability of the data they use in their own performance analysis.

#### *Are 'ground rules' the answer?*

So what does all this mean? Do we need so-called 'ground rules'? What PwC has proposed is extracted below – but can the international reporting community reach consensus and consistent application? The debate continues.

#### *Proposed 'ground rules'*

- Be clear and consistent in definitions of measures and the adjustments made.

- Apply balance when making adjustments and only use measures that are relevant for understanding performance.
- Explain the why as well as the what: why particular APMs are relevant to understanding performance and why those adjustments are made.
- Provide comparative data and restate the comparatives if definitions do change.

- Reconcile APMs to GAAP, showing adjustments clearly in a bridge, chart or table.
- Give balanced prominence to GAAP and non-GAAP measures in all communications.
- Be clear about which measures are non-GAAP, and about what is and isn't audited or subject to some other form of assurance.

You can also hear directly from investors and analysts by watching the *Investor view webcast on non-GAAP measures*.

## *The rise in power of the 'NIFRIC' – time to comment?*

**Mary Dolson, PwC Partner, looks at the latest activity at the IFRS Interpretations Committee and whether agenda rejections are having a greater effect on accounting than a formal interpretation.**

The inaugural chairman of the IASB, now retired, was vocal in sharing his view that principles-based standards shouldn't need interpretation and enforcement was the province of regulators and auditors. The IFRS Interpretations Committee (IFRS IC) emerged from a recent operational review with a mandate to 'do more'.

The IC has a number of ways to 'do something'. It can produce an interpretation, it can propose narrow scope amendments, it can recommend 'improvements' (minor changes) and then there is the 'agenda rejection'.

An agenda rejection is known in the standard setting trade as a 'Not-an-IFRIC' or a NIFRIC. A question is submitted to the IC; the staff attempt to establish if the item meets the agenda criteria and start drafting papers. If the IC concludes it will not take an item on its agenda then a draft rejection is prepared and published; interested parties can comment on the agenda decision for 60 days.

This is a certain level of due process but many draft NIFRICs attract no comment letters at all. If there are no substantive comments then the agenda decision is finalised. NIFRICs have no 'official' standing in the hierarchy of IFRS but they are referenced, certainly by regulators. There are two draft agenda rejections in July IFRIC Update that preparers in particular may want to comment on.

### *Interaction between IAS 21 and IAS 29*

The first is a draft rejection on the interaction of IAS 21 Foreign Currency and IAS 29 Accounting in Hyperinflation. A preparer pointed out to the IC that applying IAS 29 and then IAS 21 in consolidated financial statements produces an outcome that can be very different from the underlying economics if exchange rates and exchange activity are strictly controlled by the government.

The rejection says (I summarise severely): 'We acknowledge your point but the standards are clear and there's nothing for

us to interpret. Further, it's a big topic and we can't touch it with a narrow scope amendment.' The IC has not suggested any possible remedy or urged the IASB to figure out if there is some way to remediate the problem without fundamentally re-opening IAS 29 or IAS 21.

Some might wonder if this result undermines the credibility of IFRS. It's beyond the IC to fix monetary policy consequences in certain economies. However, this seems like a problem that could be solved or at least given serious consideration by the IASB.

#### *IAS 16 and test production*

The second NIFRIC is a draft rejection of a request to interpret IAS 16 'Property, plant and equipment' on what constitutes 'cost'. IAS 16.17(e) explains that the costs of testing whether an asset is functioning properly (e.g. facility) are added to the total cost of an asset after deducting the net proceeds of selling the test production.

Practice in some industries is that the cost of testing production is added to the cost of the facility, offset by any proceeds from selling test production on an aggregated basis. This has the attraction of simplicity because it eliminates the need to calculate the net cost or net proceeds of each test unit (or batch) sold. This method also avoids complicated allocations of the other costs of the facility to each unit produced. Of course, this facility is not yet being depreciated because it's not yet ready for use.

The draft rejection says that any net proceeds should go in the income statement; in other words, the simple and what some might say pragmatic approach described above is not appropriate when the proceeds exceed the specific costs of testing. The IC proposes that entities must determine net proceeds and present them as an income statement item. Net costs are still capitalised as part of the cost of the facility.

The IC's view of IAS 16 has conceptual merit and it's a reading of the standard that might be described as a victory for concepts over established practice and cost/benefit. But there is no guidance on how to apply the NIFRIC's suggested approach. For example, with or without depreciation?

An entity may have several options to maintain current practice. The standard's requirements don't apply to immaterial items; test production of a major installation of property plant and equipment may not be material. In addition, some aspects of activity in the extractive industries may be out of IAS 16's scope or in the shelter of IFRS 6 for at least the exploration and evaluation phase. But should a NIFRIC force a change in practice, introduce additional complexity or encourage the application of materiality or 'workarounds'?

Are you affected by either of these draft agenda decisions? If so, consider sharing your views with the IFRS IC.

You can follow Mary on Twitter at @MaMaDolson.

#### ***Interested in more views like these...take a look at the [IFRS blog](#)***

Recent additions to the IFRS blog include:

- [Sandra Thompson](#) asks whether the world can accept the new financial instruments standard even though it might be too little too late?
- [Dave Walters](#) takes on the 'Sage of Omaha' and accounting for business combinations.



## IASB Spotlight: Amaro Gomes

**Fernando Chiqueto speaks to IASB member Amaro Gomes about his role on the IASB and the latest developments in standard setting.**

Amaro Gomes started his second five-year term as the representative from South America on the IASB earlier this year. His previous accolades include most notably serving as a senior official of the Central Bank of Brazil.

*What are your perspectives for your second five-year term as member of the IASB?*

It will be great to see the consolidation of IFRS adoption in Latin America. This involves, for instance, the conclusion of the implementation process in Colombia and, with respect to countries already adopting IFRS, monitoring the implementation of new standards (such as IFRS 9 and IFRS 15) in order to assure consistent application of IFRS.

It is also important to expand the number of Latin American countries applying IFRS for small and medium-sized entities (IFRS for SMEs). IFRS for SMEs improves quality of financial reporting, having the advantage of reduced burden as compared to full IFRS. The vast majority of Latin American companies are unlisted and the adoption of IFRS for SMEs can help improve access to finance, which is one of the major challenges faced by such entities.

Finally, there is room for increasing the participation of Latin America in the IASB standard setting process. For instance, feedback on new accounting proposals is still incipient, particularly from institutional investors. As for standards-setters, I have participated in the creation of the Group of Latin American Accounting Standard Setters (GLASS), in 2011.

This group has a crucial role in facilitating and increasing the interaction between Latin American countries and IASB by providing technical input to proposals of new standards, amendments and interpretations.

*Brazil has adopted IFRS since 2008. Which benefits from convergence would you highlight?*

The level of savings in Brazil has been relatively low over the past decades (under 20% of GDP). Also, current government spending on public services and payment of government debt represent a significant portion of the Brazilian federal budget. This is an important issue for an economy that wants to grow.

In simple terms, domestic savings are not enough to fund the investments in infrastructure and other long-term investments, which can hold back economic growth. In this sense, foreign investments play an important role in filling the gap caused by the lack of domestic savings. In Brazil, for example, about 70% of the volume of trade on BM&FBOVESPA<sup>1</sup> comes from foreign investors. The need for good quality internationally understandable financial reports is therefore key to the Brazilian economy.

The adoption of IFRS by virtually all Brazilian companies at the individual and consolidated level, including SMEs, brought greater transparency to financial reporting in Brazil. As a result, further international sources of finance became available. Comparability of companies and enhanced communication favoured the free

<sup>1</sup>BM&FBOVESPA is the largest Exchange in Latin America and a Brazilian owned company.

flow of capital across Brazilian borders, which is unarguably one of the main benefits of using a single set of accounting standards.

Another benefit flowing from adoption of IFRS is related to cost of capital. Debt financing is the main source of capital for Latin American companies. For example, in Brazil there are fewer than 500 listed companies and an estimated figure of more than 16 million privately-held companies. The improvement in lenders' confidence resulted in lower risk and therefore lower cost of capital.

*How has the last financial crisis contributed to improve the accounting standards?*

During the last financial crisis, I was the head of the Financial System Regulation Department of the Central Bank of Brazil. We were monitoring the U.S. subprime mortgage market long before the bursting of the speculative bubble, mainly because we had a long-term project aimed at enhancing the Brazilian mortgage market and were looking into international practices. Although Brazilian banks had no exposure to subprime securities, the Brazilian market was, of course, sensitive to the observed volatility in the global economy and it had to be prepared.

As for financial reporting, the financial crisis highlighted some known concerns around the international accounting standards. As a consequence, the IASB prioritised a number of projects related to areas that needed improvement, particularly financial instruments accounting. We revised the classification and measurement introducing the business model concept, the hedge accounting, and the impairment requirements where losses will be recognised when there is significant credit deterioration, which would happen long before a loan defaults.

*With respect to the IASB main projects, what are your thoughts on convergence to U.S. GAAP not being achieved?*

I acknowledge that convergence is an important step to make worldwide capital markets more efficient. There have been significant efforts from both boards and convergence has been successfully achieved in some important areas, such as fair value measurement and revenue recognition.

In other areas we were unable to reach convergence, such as impairment of financial assets, but both the FASB and IASB are working very hard and are committed to converge.

*What is the biggest challenge currently being faced by the IASB?*

In my view, the biggest is the conclusion of important projects in our current agenda, including the ones under development for quite some time (e.g. leasing and insurance) and the conceptual framework. But there are two others I believe are also important.

First, with respect to those countries already applying IFRS, timely implementation of amendments and new standards is essential in order to ensure consistency and comparability of financial reporting.

Second, adoption by economies that currently permit but do not require the use of IFRS (e.g. Japan) is fundamental for the consolidation of IFRS as the global accounting standards.

*Who do you admire in the standard setting and why that person?*

Jan Engström. I've been a witness of Jan's work in Latin America. Jan had been directly involved (and devoted) with IFRS adoption in Latin America before I joined the Board and his achievements in promoting IFRS in the region are remarkable. Jan Engström ended his second five-year mandate as board member in 30 June 2014.

***What do you want your legacy to be?***

More inclusiveness of Latin American countries in the IASB standard setting process. The participation of such countries

is still in an evolving stage and I believe Latin America has a valuable contribution to offer to the process of international accounting standard setting.

***What do you enjoy most about your profession?***

Dealing with countries in their efforts to implement IFRS and helping them overcome the natural challenges associated with IFRS adoption. It's extremely rewarding to see the growing learning process.

***Quick-fire questions:***

***Historical cost or fair value?***

Fair value, most of the time.

***How do you commute?***

Tube.

***What is your favourite lunch place near to the IASB?***

Barbecoa.

***Balance sheet or income statement?***

Both - with transparency.

***Which position do you play (football)?***

It was supposed to be a football-related question...In fact Amaro played basketball as forward and has had a 'quite rewarding career'.



***PwC's Accounting Consulting Services bids farewell to Caroline Woodward, our Queen of Valuation and Impairment***

Caroline Woodward's career at PwC will come to a close on 30 September after 39 years with the firm. Caroline joined the audit practice in 1975 in Reading, UK. Since then she has worked all over the globe spending a number of years in Eastern Europe including time in Bratislava and the Ukraine. She moved back to London in 1999 to the valuation team and joined Global Accounting Consulting Services in 2003 for the beginning of adoption of IFRS in Europe.

Caroline has been a frequent contributor to IFRS news on a number of topics, most notably business combinations, fair value and impairment and I can assure you that she held the pen on anything to do with agriculture. Many might say it is a shame she will not be able to share her views on the upcoming exposure draft on IFRS 13 and the unit of accounting (aka 'P times Q').

Thanks Caroline for your invaluable contribution over the years.

***Guide to revenue from contracts with customers - 2014 edition***

This guide describes the accounting under IFRS 15, the converged IFRS and US GAAP revenue standard issued in May 2014. It assists in understanding and evaluating the accounting for revenue transactions. The **guide** is available for download on Inform.



## Cannon Street Press

### IAS 27 narrow scope amendment

The IASB has amended IAS 27 'Separate financial statements' to restore the option to use the equity method to account for investments in subsidiaries, joint ventures and associates in an entity's separate financial statements.

An entity can now account for investments in subsidiaries, joint ventures and associates in its separate financial statements at cost, in accordance with IFRS 9, or using the equity method as described in IAS 28.

The amendments are expected to reduce compliance costs for entities that are required to prepare separate financial statements in which they account for investments in subsidiaries, joint ventures and associates using the equity method.

An entity electing to change to the equity method shall apply the amendments for annual periods beginning on or after 1 January 2016 in accordance with IAS 8. Earlier application is permitted.

### Exposure draft: IAS 12 narrow scope amendment

The IASB has proposed amendments to IAS 12 on deferred tax asset recognition for debt instruments measured at fair value. The exposure draft (ED) also suggests a new illustrative example. The comment period ends on 18 December 2014.

The ED proposes to clarify the following:

- unrealised losses on debt instruments measured at fair value and with a tax base at cost give rise to a deductible temporary difference irrespective of whether the holder expects to recover the carrying amount by sale or use;

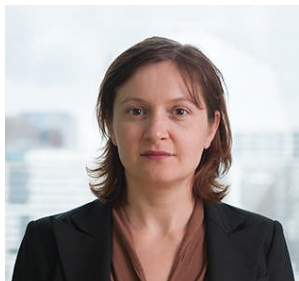
- the extent to which the estimate of future taxable profits considers recovery of assets for more than their carrying amount;
- that estimates of future taxable profits should exclude tax deductions resulting from the reversal of deductible temporary differences; and
- an entity should assess recognition of a deferred tax asset in combination with other deferred tax assets of the same type based on how the tax law restricts the utilisation of tax losses.

### IASB work plan

The IASB has finally released IFRS 9 and IFRS 15, but there a number of projects still in the pipeline. Below is a summary of the IASB workplan that will be waiting for the IASB after its summer break.

The board also continues discussions on narrow scope amendments, a number of annual improvements and a growing research agenda.

Project	Next steps	Expected date per Work plan
Leases	Redeliberations	Ongoing in H2 2014
Insurance	Redeliberations	Ongoing in H2 2014
Rate regulated activities	Discussion paper	Q3 2014
Conceptual Framework	Exposure draft	Q1 2015
Macro hedging	Public consultation	Comment period ends Q3 2014
Disclosure initiative	Redeliberations	Ongoing in H2 2014, some narrow scope amendments expected later in H2 2014



## ***Know your IFRS ‘ABC’: S is for service concession arrangements***

**Codina Petrescu from PwC’s Accounting Consulting Services recaps the accounting for service concessions.**

Historically governments have taken responsibility for public services – construction, operation and maintenance of infrastructure. But there is a growing number of countries where the government has introduced arrangements with private sector participation as part of the strategy to improve public services.

These arrangements, as with any government contract, can be complex. Private sector operators need to consider whether and how they should apply the guidance in IFRIC 12 on service concessions accounting.

Let’s look at what types of agreements represent a service concession arrangement and how they should be accounted for.

### ***The basics at a glance***

#### ***Scope***

Operators in public-to-private arrangements for the delivery of public services should apply service concession accounting where the use of the infrastructure is controlled by the grantor. This is when:

- the grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price; and
- the grantor controls any significant residual interest in the infrastructure at the end of the term of the arrangement or the arrangement is for the entire useful life of the infrastructure.

#### ***Accounting for construction or upgrade***

Depending on the terms of the concession, the operator that builds or upgrades infrastructure will record either:

- a financial asset - when the operator has an unconditional contractual right to receive cash or another financial asset from the grantor;

- an intangible asset - when the operator receives a right to charge users (for example, operator collects tolls from users of a road); or
- both an intangible and financial asset.

This means that the construction or upgrade of the infrastructure done by the operation will not be accounted for as property, plant and equipment of the operator. This might seem counterintuitive especially if the entity both constructed and operates the asset. The idea is that the operator does not have the right to control the infrastructure, it only has access to operate the infrastructure on the grantor’s behalf. The operator is regarded as a service provider for the grantor and has the right to access the infrastructure controlled by the grantor.

The operator will record construction revenue and construction costs under IAS 11. The construction services are provided in exchange for consideration in the form of a right to receive cash from the grantor (financial asset) or a right to charge users (intangible). As this represents an exchange transaction, construction revenue and financial asset/intangible should be recorded at fair value (not at the cost of construction).

### ***The devil is in the detail***

#### ***Scope***

Traditionally, operators see the infrastructure they are constructing as their own fixed assets. As such, a lot of challenges were raised by operators looking to argue that they are not in scope of the service concession arrangements accounting.

#### ***What is a public service infrastructure?***

A key feature of service concession arrangements is the public service nature of the obligation. The challenge is that the term ‘public service obligation’ is not defined and as such judgment should be applied.

Generally, public services include services provided by governments to its citizens, with the purpose of meeting their basic needs for modern living and to cater for their fundamental rights. IFRIC 12 gives a number of examples including: roads, bridges, prisons, hospitals, energy supply networks.

To look at one of these examples: a prison is considered to be used for the provision of a public service, as it fulfils a key public function of protecting the public by removing criminals from society.

However, a military office building is out of scope. While it enables the government to carry out its defense policies, it is not used directly for the provision of a public service to members of the public.

#### *Control or regulation of prices*

One of the criteria for a service concession is for the prices to be controlled or regulated.

The grantor does not need complete control of the prices. It is sufficient for the price to be regulated - by the grantor, contract or the regulator. This can include a maximum price (cap) or a price formula (even if the formula includes a component outside of grantor's control, such as a price index).

If the regulation imposes a cap or requires the operator pay excess profit over a cap, you need to look at whether it is substantive. A cap that only applies in remote circumstances has no substance and is ignored, taking the arrangement out of scope.

If the prices are only part regulated, then we would look at whether that part is capable of being operated individually. For example, a private wing of a hospital might not have regulated prices, and hence will be out of scope. The rest of the hospital is used to treat public patients, will have regulated prices and will be in the scope of IFRIC 12.

#### *Control of residual interest*

There are a number of ways in which a grantor can control the residual. The most common is when the operator must hand over the infrastructure to the grantor at the end of the arrangement.

Another is where the grantor has an option to buy the infrastructure at the end, regardless of whether it is at market price at that time or a pre-determined amount.

The requirement for the infrastructure to revert to the grantor only in exceptional circumstances (for example, major breach of the arrangement) does not necessarily indicate that the grantor has control.

#### *Accounting*

The main reason why many want to avoid IFRIC 12 is the complexity of its accounting. Let's have a look at two examples.

##### *Type of asset - shortfall guarantee*

The operator might have the right to charge users, but the grantor guarantees to pay the shortfall, if any, between what is collected from users and a pre-determined level.

The operator should record both a financial asset for the unconditional right to receive the minimum guaranteed amount and an intangible asset for the right to earn amounts from users in excess of the guarantee.

This creates complexities especially when the arrangements are modified. Intangible assets are not remeasured under IAS 38 and IAS 39 has specific guidance for financial assets. Application of the guidance for arrangements with both financial and intangible asset might have an unusual outcome.

##### *Obligation to maintain the infrastructure*

Where an operator has a contractual obligation to maintain or restore the infrastructure it must recognise this as a provision in accordance with IAS 37. No such provision will be recorded for any obligation to upgrade the infrastructure.

But sometimes it is hard to distinguish between these obligations. For example, take resurfacing a toll road – is it a contractual obligation to be provided for, an upgrade for which no provision is made or just a separate service for which revenue is recognised when performed? Even the examples in IFRIC 12 look at this in different ways.

These are only two examples of the complexities. So you can understand why many spend time first looking at scope!

## *The bit at the back.....*



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