



IFRS news

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Financial volatility – here to stay?

January has been marked by continued financial volatility. Let's look at what this means for year-end accounting.

Recent months have been marked by increased volatility in global markets, falling oil prices, political unrest and slower than expected recovery in the Eurozone. Volatility comes in all shapes and sizes – exchange rates, commodity prices and interest rates – and it often means a volatile income statement.

The current economic environment has driven many to ask questions as they prepare year-end financial reporting. Let's have a look at some of the key issues.

Exchange rates

Exchange rates have been a recurring feature in the headlines. Most recently, the Swiss Franc was 'unpegged' from the Euro, removing the cap put in place some years ago. Skiing holidays suddenly became more expensive for many but more importantly, the price of Swiss shares suffered a significant fall. The Russian Rouble is going in the other direction with falling oil prices a major contributing factor. This has generated an increase in interest rates and a fall in the Russian stock market.

Nevertheless, IAS 21 requires the use of spot exchange rates at 31 December. For example, Swiss entities will need to consider the recent foreign exchange movements as a subsequent event and assess the level of disclosure they want to make regarding this issue. [[For more information see alert](#)].

Risk management

The turmoil in the economic environment affects more than just foreign currency.

There are knock-on effects in other areas, for example, decreased revenue in the oil and gas industry and changes in the cost of manufacturing for others.

Some might look to hedge accounting to minimise volatility in the financial statements. This might mitigate exposure but hedge accounting has to be applied prospectively. Hedge accounting is well known for its documentation requirements. Therefore, entities will not be able to defer volatility if no hedge relationship formally existed in 2014. There is also a risk that existing hedge relationships might no longer be effective and consequently might not be able to continue applying hedge accounting.

Negative interest rates

Negative 'real' interest rates have returned to the forefront of discussions against the backdrop of the economic crisis. Although negative interest rates are not a new phenomenon, the scale being experienced today is indeed new. The most notable instance is the European Central Bank's (ECB's) decision to cut interest rates on its deposit facility to -0.2% in September 2014, thereby charging banks for holding funds overnight. But what is 'negative' interest – is it really interest?

The Interpretations Committee (IC) has been discussing this very matter. The IC confirmed this month that interest arising from a negative interest on a financial asset does not meet the definition of interest revenue in IAS 18 because it is a gross outflow, instead of a gross inflow of

economic benefits. Negative interest must therefore be presented in an appropriate expense classification. Entities are encouraged to disclose where they present negative interest and the amount. The final IC agenda decision is expected in February 2015 - watch for updates on this topic.

Discount rates

Discount rates should reflect the conditions at year-end. Post year-end volatility is a non-adjusting subsequent event (similar to changes in exchange rates), which should be supported by sensitivity disclosures.

But what does negative interest mean for discount rates? Does it make sense to measure a long term provision expected to be settled at CU90 in 30 years in today's balance sheet for CU100? It seems unlikely. Negative interest rates in the long-term are likely to be combined with deflation, limiting the extent to which real rates are negative. It is also important to remember that the discount rate should reflect both the risks associated with the liability as well as time value.

Impairment

All these examples of doom and gloom are potential indicators of impairment and are likely to lead to an increase in impairment reviews of non-financial assets. The

widespread slowdown means that assets and businesses in many industries will generate lower cash flows than expected, increasing the likelihood that impairment will be required.

If an impairment review results in a "near miss" the methodology probably needs a second look. First and foremost, the cash flows should be risk adjusted. A single point estimate is not risk adjusted. If a single set of cash flows is used, adequate risk should instead be built into the discount rate.

Also, the carrying amount of the cash generating unit (CGU) should be consistent with how the recoverable amount is determined. Only assets that generate future cash flows used to determine the value in use are included. Liabilities are not included unless the recoverable amount cannot be determined without their consideration.

If after review there is still a near miss, additional disclosure is required including the sensitivity of key assumptions. Impairment is always a hot topic with regulators and therefore disclosures need to be transparent.

For more information, check out [Top 5 tips for impairment reviews of non-financial assets](#).

Revenue TRG makes a dent in the implementation issue list

The Revenue Transition Resource Group (TRG) met this month for the third time to discuss implementation issues related to the new revenue standard.

There is no relief in sight for the Revenue TRG as the list of potential implementation issues on the IASB/FASB joint revenue standard keeps growing. Some implementation challenges were expected given the level of change, but the growing list creates uncertainty for preparers about the potential impact on the effective date.

The staff gave an update on several issues discussed at previous meetings. Further

discussion is expected at the February joint board meeting, including the results of the ongoing outreach to date on licenses and identification of distinct goods or services.

Stakeholder outreach at the FASB related to the potential delay in the effective date is still ongoing. An announcement is expected in early Q2 2015. The IASB is following the discussions but has given no indication of whether deferral under IFRS is a possibility.

Highlights of the January meeting

The TRG discussed eleven new issues at the January meeting. Some issues are likely to result in further discussion by either the TRG or the boards. The following four areas were specifically identified as potentially requiring further action.

Identifying promised goods or services

Some have questioned whether more promised goods or services will be identified under the new standard as compared to current practice. In particular, the Basis for Conclusions states that an entity is not exempt from accounting for 'perfunctory or inconsequential' obligations. This has received attention from US GAAP preparers. Current US GAAP permits recognition of all revenue if the remaining obligations are inconsequential or perfunctory.

TRG members observed that they do not believe the new guidance was intended to require the significantly more performance obligations than existing practice, except for certain promises previously accounted for as marketing under US GAAP. TRG members cautioned that potential unintended consequences should be carefully considered if the boards decide to include in the standard guidance to exempt an entity from accounting for inconsequential or perfunctory performance obligations.

Noncash consideration

The new standard requires entities to measure the fair value of noncash consideration (for example, equity instruments or advertising) and include it in the transaction price. Some question whether the standard is clear on when noncash consideration is measured and how to apply the variable consideration constraint. TRG members expressed a range of views and some suggested it would be helpful if the standard was clarified.

Contract modifications on transition

The new standard requires an entity to consider all modifications since inception for contracts in progress at the date of initial application. Some have indicated that the cost of applying this requirement is not justified by its benefits and requested the boards to consider adding a practical

expedient on transition. Many of the TRG supported an expedient, although discussion on the form of relief was limited.

Collectability

Several TRG members observed that the guidance for contracts where collectability is not probable does not reflect the economic substance in some circumstances. For example, consider a five-year service contract with a customer with poor credit, where service is performed and cash is collected monthly. Some TRG members observed that the standard might be interpreted to prohibit revenue recognition until the contract is terminated, there are no remaining performance obligations (at the end of five years), or collection of the entire transaction price becomes probable. The boards might consider further discussion or outreach.

Other areas discussed

The following other areas were discussed but no significant further action is expected:

- stand-ready obligations;
- costs to obtain a contract;
- variable payments to customers and the level at which to apply the variable consideration constraint; and
- Islamic finance transactions.

Topics for a future TRG meeting

The TRG began discussions on three other issues. The staff has yet to complete their analysis and only sought initial views on the following issues:

- material rights including the accounting upon exercise;
- applying the guidance on consideration payable to a customer; and
- identifying and accounting for a significant financing component.

The next steps

The next steps might be clearer at the February joint board meeting when the boards will discuss potential actions on some of issues raised by the TRG to date. It seems we might need to wait until the second quarter for more information on whether mandatory adoption will be deferred, at least for US preparers.

For more information, see a full summary of the January TRG in [In Transition](#).

Is the EU really committed to IFRS?



Does the EU still think the adoption of IFRS was a good idea? Ten years on, Christopher Nobes, Professor of Accounting at the Universities of London and Sydney, takes a look.

This article was published by World Watch. For the full article, follow this [link](#).

The EU Regulation of 2002 required listed companies to use EU-endorsed International Financial Reporting Standards for their consolidated statements from 2005 onward. The Regulation was really an admission that trying to harmonise accounting using national laws had not worked well enough.

The new rules put EU-IFRS above most of the requirements of national laws. The idea was to improve comparability of reporting, to strengthen capital markets. The Regulation also allows member states to extend IFRS voluntarily or compulsorily to unconsolidated statements. The UK and the Netherlands do so, but France and Spain do not, for example.

For political and legal reasons, each new or amended part of IFRS has to go through the EU machinery for translation and endorsement. Sometimes this can take well over a year – and even then, the endorsement may not be exact (e.g., IAS 39, Financial Instruments).

In some places, elements of – or the whole idea of – IFRS have been criticised. Partly for this reason, and partly because it is good modern practice to conduct post-implementation reviews, the EU issued a consultation document with responses due in November 2014.

The consultation looked for responses to such questions as: has IFRS improved the quality of financial reporting, and does the endorsement mechanism work properly?

There has been plenty of research on the first question already, and the ICAEW recently reviewed that in a publication.

In summary, the research shows that IFRS has improved international comparability

and reduced the cost of capital. But does the EU's consultation conclude the same?

Highlights of the responses

The vast bulk of responses were in favour of IFRS. Of the respondents giving a clear answer, 93% took a positive attitude to IFRS. This is remarkable backing.

A very high proportion of all types of respondent considered that IFRS has improved comparability – even within their own country.

Virtually all respondents considered that the rationale for the Regulation remains in place and that it has furthered harmonisation. There was also considerable support for extending the scope of the Regulation in various ways.

There was very widespread support for the existing EU endorsement process. Some respondents, however, complained about the slow endorsement of some standards and a few recommended removing the “European public good” criterion on grounds of vagueness. Several warned against adding to the criteria because it might risk the lack of endorsement.

Conclusion

There was probably little appetite in the Commission – or in most member states – for any substantial change to the IAS regulation. What would be the alternatives? US GAAP would be too detailed, and politically impossible, while European standards would become the plaything of national governments.

In conclusion, the results of the consultation enable the Commission to congratulate itself on creating the Regulation and to demonstrate that there is no substantial demand for change. So, steady as she goes.

Cannon Street Press

Disclosure Initiative

Two milestones have been achieved: narrow-scope amendments to IAS 1, applicable as of 1 January 2016, and an ED on narrow-scope amendments to IAS 7 were issued last December. The IASB met in January and discussed during an education session the status of the other subprojects of the Disclosure Initiative (DI).

Materiality

The IASB plans to expose a practice statement in Q2 2015. The Principles of Disclosure (POD) discussion paper (DP) will also include a section on materiality.

Principles of Disclosure

The POD (DP) is planned for mid-2015 and is expected to cover cohesiveness, the format of the notes, cross-referencing, purpose of the primary financial statements and the notes, and communication principles. Some topics, such as the structure of the primary statements, are planned to be covered by the Performance Reporting project (which is not formally part of the DI).

Review of existing disclosure requirements

IAS 1, IAS 7 and IAS 8 are currently being reviewed with the support of other standard

setters. The IASB still plans to review disclosures in existing Standards to identify and assess conflicts, duplication and overlaps. No timeline has yet been published.

Digital reporting

The IASB has for the first time included proposed changes to the IFRS Taxonomy in the ED on IAS 7 issued in December. The IASB has asked for comments on whether and in which form the proposed changes to the IFRS taxonomy should be included in EDs going forward.

Behavioural change

The underlying assumption (and hope) of the IASB is to lead to a behavioural change of the users, resulting in more relevant information, less irrelevant information and better communication.

This change in mindset is expected to lead to an overall improvement in the effectiveness of disclosures. This part of the project might be the most difficult one to achieve, as objectives-based disclosure requirements will inevitably be interpreted differently by users.

IASB discussions on employee benefits

IFRIC 14 and the asset ceiling

The IASB tentatively agreed to amend IFRIC 14 to clarify that an entity should not recognise a surplus as an asset when another party (for example, the trustee) has the unilateral power to use it for other purposes. The unilateral power to buy annuities or make other investment decisions without changing the pension promise is a power to make investment decision and thus is different from the power to wind up the plan or the power to use a surplus to enhance benefits.

Where a scheme is subject to a 'minimum funding requirement' this may lead to more employers having to recognise an additional liability for future contributions required in respect of past service.

IAS 19 and settlements

The IASB also tentatively agreed to amend IAS 19 to clarify that a settlement gain or loss or past service cost should be calculated and recognised in profit or loss where the cost will be met out of unrecognised surplus. The proposal will also clarify that current service cost and net interest for the remaining period should be determined using the assumptions applied to the remeasurement and the net interest should be calculated based on the remeasured net defined benefit liability (asset) following the plan change.

An exposure draft is expected in the second quarter of 2015.

Know your IFRS 'ABC': W is for 'Written put'



Dr. Holger Meurer from PwC's Accounting Consulting Services describes why a written put on an entity's own equity instruments is not just a derivative

Management is always looking for ways to attract potential shareholders. One way is to offer them a kind of 'parachute' – a right to return their shares to the entity.

From the entity's perspective, an obligation to purchase its own equity instruments either at discretion of a third party (written put) or due to a binding contract (forward), at first glance, just looks like a derivative instrument that has to be measured at fair value.

This is only half the truth...

The basics

Recognition of a redemption liability

IAS 32 tells us that a contract that contains an obligation for an entity to purchase its own equity instruments gives rise to a financial liability for the present value of the redemption price (for example, the repurchase price of a forward contract or the exercise price of an option). This is the case even if the derivative itself is an equity instrument.

The rationale behind this accounting treatment is to account for the derivative 'as if' the future transaction has already occurred. The underlying equity instruments are deducted from equity. The redemption amount is recognised as a liability.

Measurement of the redemption liability

The redemption liability is recognised initially at the present value of the redemption price. It is subsequently measured at amortised cost using the effective interest rate method.

Measurement of the redemption liability could get quite tricky if the redemption price is not a fixed price but based on a formula (for example, EBITDA) or fair value. The carrying amount of the redemption liability has to be adjusted periodically as the redemption amount fluctuates over time. The carrying amount is recalculated by computing the

present value of the new redemption amount at the original effective interest rate (following the guidance in IAS 39.AG8). Any difference is recognised as a finance charge in the income statement.

The carrying amount of the financial liability is reclassified as equity if the contract expires without delivery.

Puts and NCI

Derivatives over shares relating to non-controlling interest

What if the underlying of the derivative is an equity instrument of a subsidiary not attributable to the parent (that is, non-controlling interest or 'NCI')? The contract also results in the recognition of a redemption liability. And now the 'debit' gets exciting.

The 'debit' depends on whether significant risks and rewards of ownership of the underlying shares are transferred to the parent. If so, our view is that the redemption liability is offset against NCI (or if part of a business combination, NCI is not recognised). A transfer of risks and rewards arises, for example, for a fixed price forward or a fixed price put accompanied by a fixed price call.

If the risks and rewards remain with NCI, the redemption liability reduces controlling interest equity (that is, retained earnings). This results in a double credit accounting – the entity presents a redemption liability and NCI within equity. Risks and rewards of ownerships reside with NCI, for example, in case of a fair value forward.

Don't forget IFRS 12

IFRS 12 requires extensive disclosures for subsidiaries that have material non-controlling interests. The requirements in IFRS 12.12 are not relevant if no non-controlling interests are recognised. This does not mean that you can ignore IFRS 12.

The entity will still need to disclose the nature of protective rights held by the non-controlling interests and the extent to which these rights could limit the entity's ability to access or use assets and settle liabilities of the group (IFRS 12.13(b)).

Example

Let's look at an example.

- Parent A acquires 80% interest in subsidiary B for C4,500.
- The fair value of the identifiable net assets of subsidiary B is C5,000.
- Parent A and the non-controlling shareholders of B enter into a forward agreement at acquisition date to purchase the remaining 20% of B after two years.
- Discount rate is 10%.

Case 1 – Fixed price forward

The forward purchase price is fixed at C 1,100. Accordingly, significant risks and rewards of ownership of the underlying shares are transferred to the parent.

Dr. Net assets	C5,000	
Dr. Goodwill	C409	
Cr. Redemption liability		C909
Cr. Cash		C4,500

(redemption liability = C1,100 / 1.1²)

Case 2 – Fair value forward

The forward purchase is the fair value of the 20% interest in B. The fair value of the non-controlling interest is estimated to be C1,100. In this case, risks and rewards of ownership reside with the non-controlling interests.

Dr. Net assets	C5,000	
Dr. Goodwill	C500	
Cr. NCI		C1,000
Cr. Cash		C4,500

(NCI = 5,000 × 20%; proportionate share method)

Dr. Parent equity	C909	
Cr. Redemption liability		C909

... and what about puttable instruments?

Some financial instruments, often issued by partnerships or co-operative entities, allow the holder to 'put' the instrument (that is, to require the issuer to redeem the instrument for cash.) These instruments are classified as equity instruments by the issuer under certain circumstances described in IAS 32.16A and B.

However, puttable instruments that are classified as equity in the financial statements of the issuing subsidiary are always classified as financial liabilities in the consolidated financial statements of the parent entity. The reason for this is that the IASB has decided not to extend the exception in IAS 32.16A and B to the classification of non-controlling interests (IAS 32.AG29A). These instruments are recognised as financial liabilities from the beginning and there is no room for any non-controlling interests within equity (that is, a 'double credit accounting').

This is the case even if the non-controlling interests are exposed to significant risks and rewards of ownership.

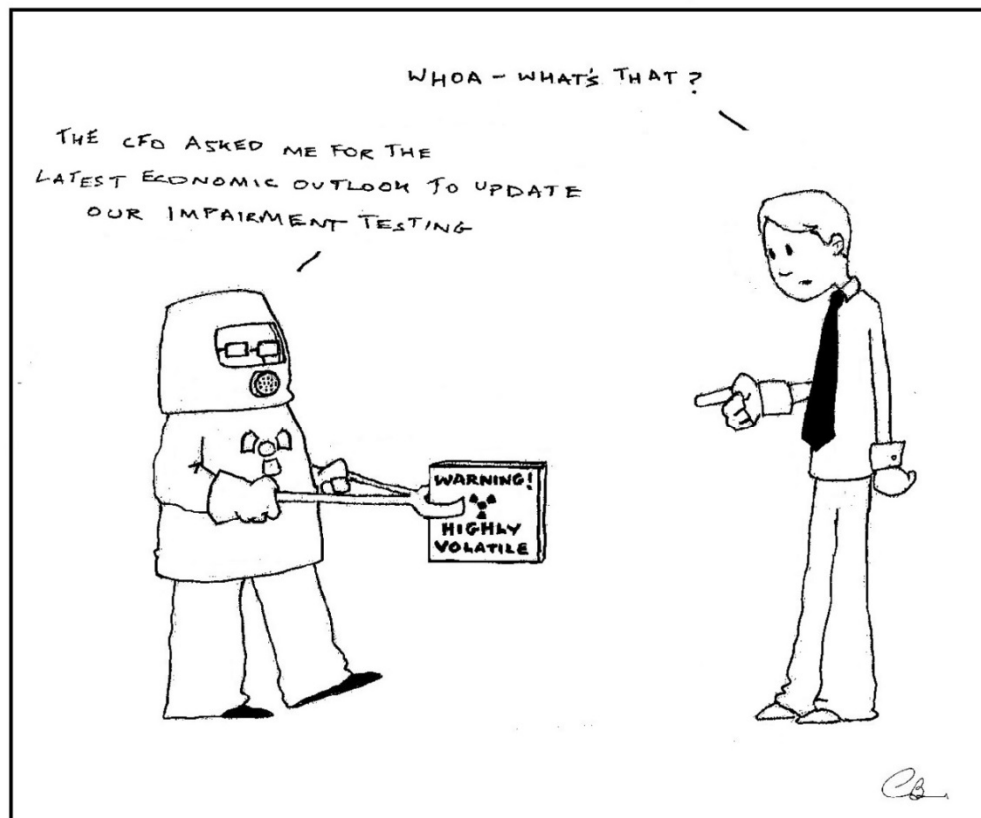
The IC debate

The IASB and IFRS Interpretation Committee (IC) have spent countless hours looking at the accounting for subsequent changes in the measurement of put options written on non-controlling interests (NCI puts). They initially proposed to account for such changes in the income statement. Many would argue that this accounting does not make sense. The better the entity performs, the higher the liability and the more expense in the income statement. The debate has yet to be finalised.

There is currently diversity in practice. Some account for subsequent changes in the financial liability in profit or loss in accordance with IAS 39 or IFRS 9. Some account for subsequent changes in the financial liability as equity transactions (that is, transactions with owners in their capacity as owners) in accordance with IAS 27 and IFRS 10.

Take a look at one man's view in the latest [IFRS blog](#).

The bit at the back.....



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