IFRS news

IASB and FASB agree approach for debt investments

In this issue:

1 **Financial instruments**
Boards agree approach for debt investments

3 **Cannon Street Press**
Improvements project 2011

Improvements project 2012 exposure draft

Draft IFRIC on levies

Draft IFRIC on put options

6 **New board line-up**
Appointments to IASB and IFRS IC

7 **IFRS quiz**
Impairment

10 **Contacts**

The IASB and FASB discussions on financial instruments accounting are nearly complete. Jessica Taurae looks at the latest progress.

The IASB and FASB announced in January 2012 that they would work together and redeliberate selected aspects of their classification and measurement models to reduce key differences. Since then, they have been focusing on the following areas:

- the contractual cash flow characteristics of an instrument;
- the need for separation of embedded derivatives from financial assets;
- the basis for and scope of a possible third business model (debt instruments measured at fair value through other comprehensive income); and
- any knock-on effects from the above (for example, the model for financial liabilities in the light of the financial asset decisions).

The boards' discussions on the above are nearly complete and have substantially converged in a number of key areas, including the approach to classify and measure debt investments.

What are the key decisions so far?

Debt investments (such as loans and debt securities) under IFRS and US GAAP will be classified based on an individual instrument's characteristics of contractual cash flows and the business model for the portfolio. The boards agreed last month on how these instruments are measured, with the IASB and FASB agreeing on a third measurement category: debt investments are measured at fair value, with changes in fair value recognised through other comprehensive income. The categories for debt investments are therefore broadly as follows:

- *Amortised cost –* consists of eligible debt investments (if they pass the contractual cash flow characteristics assessment) that are in a business model where the primary objective is to hold the assets to collect its contractual cash flows.
- *Fair value with changes in fair value recognised in other comprehensive income (FVOCI)* – consists of eligible debt instruments if they pass the contractual cash flow characteristics assessment and are held within a business model whose objective is to hold financial assets to collect contractual cash flows and sell financial assets. The boards are expected to provide application guidance on the types of business activity that would qualify for the FVOCI model. Interest income and impairment would be recognised in the income statement in a manner consistent with the amortised cost category; fair value changes would be recycled from other comprehensive income to the income statement when the asset is sold.
- *Fair value with changes in fair value recognised in profit and loss* – consists of debt investments that either (1) do not meet the instrument characteristics criterion, or (2) meet the instrument

characteristics criterion but do not meet one of the other categories (that is, they fall into 'the residual category'). For example, a portfolio held for trading or a portfolio managed with the objective of realising cash flows through active and frequent sales do not qualify for amortised cost or FVOCI.

One of the financial services industry's key concerns is where traditional liquidity portfolios will be classified. Many are likely to fall in FVOCI; some might continue to fall into the amortised cost category. However, it is unclear to what degree that will be the case until we see the exposure draft.

The FASB agreed to adopt the IASB requirement for reclassifications between categories when there is a significant change in business strategy, which is expected to be 'very infrequent'.

In previous meetings, the FASB also agreed to incorporate several aspects of IFRS 9 into their proposed model, including:

- Similar guidance for the instrument's characteristics test for contractual cash flows; and
- Hybrid financial assets that contain cash flows that are not solely principal and interest would not be eligible for separation (that is, they would be classified and measured in their entirety at fair value through profit or loss).

Has convergence been achieved?

Most of the points for joint discussion have now been concluded. The boards have agreed on a substantially converged approach for debt investments, although they do not plan on addressing all differences in their respective approaches (for example, classification and measurement of equity investments).

Who's affected?

The final guidance will likely affect entities across all industries that hold financial instruments.

What's the effective date?

The FASB must still complete its redeliberations before deciding on an effective date. The IASB had previously decided to extend the effective date for IFRS 9 to annual periods beginning on or after 1 January 2015. Time will tell if the IASB will delay the effective date further.

What's next?

The boards are still expected to discuss some remaining issues over the next quarter, including transition and disclosures. The IASB is expected to issue an exposure draft on these proposals in quarter 4. The FASB will separately address a number of other matters in the coming months before issuing an exposure draft later this year. It is unclear at this time whether the new impairment approach will be included in that document or issued as a separate exposure draft (for example, classification and measurement of equity investments).

'Practical guide' to response to re-exposed revenue ED

The FASB and IASB received around 360 comment letters in response to the updated exposure draft, issued in November 2011. We have summarised the feedback generally and addressed some of the industry-specific concerns.

The industry responses we have analysed are:

- Aerospace and defence
- Automotive
- Consumer industrial products
- Engineering and construction
- Entertainment and media
- Financial institutions
- Pharmaceutical, life sciences and health care
- Technology
- Telecoms

The practical guide is now available on PwC inform.

Cannon Street press

Improvements projects

There are currently a number of ‘Improvements projects’ at various stages of development:

- the final 2011 improvements (with effective dates of annual periods on or after 1 January 2013 – see below);
- an exposure draft for the 2010-12 cycle (with most effective dates likely to be annual periods on or after 2014 and one for 2015 – see next page); and
- the 2011-2013 improvements still under discussion but due to be published Q3 this year (with effective dates likely to be annual periods on or after 2014, although this is still under discussion).

The table below identifies the more significant changes to the standards arising from the 2009 to 2011 annual improvements project and the implications for management. The article on the following page outlines the proposals in the 2010-12 cycle.

Improvements project 2011

Standard	Amendment	Practical implications
Amendment to IFRS 1, ‘First time adoption of IFRS’	The amendment clarifies that an entity may apply IFRS 1 more than once under certain circumstances.	• An entity that previously applied IFRS but then stopped is permitted but not required to apply IFRS 1 when it recommences applying IFRS. • The IFRS 1 provisions are designed to ease the process of transition to IFRS. For an entity that was previously an IFRS preparer, applying IFRS 1 as if no IFRS financial statements had ever been prepared may be more burdensome than simply resuming the preparation of IFRS financial statements. The amendment permits a choice of whether to apply IFRS 1. • To avoid abuse, the amendment requires management to disclose why it stopped preparing IFRS financial statements and why it has resumed.
Amendment to IFRS 1, ‘First time adoption of IFRS’	The amendment clarifies that an entity can choose to adopt IAS 23, ‘Borrowing costs’, either from its date of transition or from an earlier date.	From whichever date the entity chooses to adopt IAS 23: • Borrowing costs under previous GAAP are not restated; and • IAS 23 applies to borrowing costs on qualifying assets that were under construction at the date of transition, irrespective of whether borrowing costs were capitalised under previous GAAP.
Amendment to IAS 1, ‘Presentation of financial statements’	The amendment clarifies the disclosure requirements for comparative information when an entity provides a third balance sheet either as required by IAS 8, ‘Accounting policies, changes in accounting estimates and errors’, or voluntarily.	• When an entity produces an additional balance sheet as required by IAS 8, the balance sheet should be as at the date of the beginning of the preceding period – that is, the opening position. No notes are required to support this balance sheet. • When management provides additional comparative information voluntarily – for example, statement of profit and loss, balance sheet – it should present the supporting notes to these additional statements.

Amendment to IFRS 1 as a result of the above amendment to IAS 1	The consequential amendment clarifies that a first-time adopter should provide the supporting notes for all statements presented.	• A first-timey adopter should provide supporting notes for its transition balance sheet.
IAS 16, 'Property, plant and equipment'	The amendment clarifies that spare parts and servicing equipment are classified as property, plant and equipment rather than inventory when they meet the definition of property, plant and equipment.	• The previous wording of IAS 16 indicated that servicing equipment should be classified as inventory, even if it was used for more than one period. Following the amendment, this equipment used for more than one period is classified as property, plant and equipment.
Amendment to IAS 32, 'Financial instruments: Presentation'	The amendment clarifies the treatment of income tax relating to distributions and transaction costs.	• Prior to the amendment, IAS 32 was ambiguous as to whether the tax effects of distributions and the tax effects of equity transactions should be accounted for in the income statement or in equity. • The amendment clarifies that the treatment is in accordance with IAS 12. So, income tax related to distributions is recognised in the income statement, and income tax related to the costs of equity transactions is recognised in equity.
Amendment to IAS 34, 'Interim financial reporting'	The amendment clarifies the disclosure requirements for segment assets and liabilities in interim financial statements.	• The amendment brings IAS 34 into line with the requirements of IFRS 8, 'Operating segments'. • A measure of total assets and liabilities is required for an operating segment in interim financial statements if such information is regularly provided to the CODM and there has been a material change in those measures since the last annual financial statements.

Exposure draft on improvements project 2010-12

The ED for the 2010-12 cycle of the annual improvements project, once finalised, is expected to apply for annual periods beginning on or after 1 January 2014 except for the amendment to IFRS 3, which applies to business combinations on or after 1 January 2015.

The Board is asking for comments on the transition provisions and the effective date of each proposed amendment, for the first time. The deadline for comments is 5 September 2012.

Classification

IAS 1, 'Presentation of financial statements'

A liability is classified as non-current if the entity expects, and has the discretion, to re-finance or roll over an obligation for at least 12 months after the reporting period under an existing loan facility with the same lender on the same or similar terms.

IAS 7, 'Statement of cash flows'

The classification of capitalised interest follows the classification of the asset to which the interest payments were capitalised.

Measurement

IAS 12, 'Income taxes'

The amendment clarifies how an entity recognises deferred tax assets for unrealised losses: if tax law restricts the use of tax losses to income of a certain type, the entity assesses whether it expects sufficient taxable income of that type to recognise a deferred tax asset; taxable profit against which an entity assesses a deferred tax asset for recognition is the amount before reversal of any deductible temporary differences; a tax-planning opportunity is an action that creates or increases taxable profit.

IAS 16, 'Property, plant and equipment', and IAS 38, 'Intangible assets'

The amendment clarifies how the accumulated depreciation should be calculated at the date of valuation when the revaluation model is applied.

IFRS 2, 'Share-based payment'

The definition of 'vesting conditions' is either a 'performance condition' or a 'service condition'.

IFRS 3, 'Business combinations'

Contingent consideration that meets the definition of a financial instrument is classified either as equity or a financial liability in accordance with IAS 32. The reference to other IFRSs is removed. Contingent consideration classified as a financial liability is subsequently measured at fair value, with changes in fair value being presented in profit or loss or in other comprehensive income, depending on the requirements of IFRS 9.

IFRS 13, 'Fair value measurement'

The amendment to the Basis for Conclusions clarifies that the Board did not intend the changes made to IFRS 9 and IAS 39 by IFRS 13 to remove the ability of entities to measure short-term receivables and payables without discounting when the effect of discounting is not material.

Disclosure

IAS 24, 'Related party disclosures'

The definition of 'related party' is extended to include entities that provide management services to the reporting entity. Disclosure is required of amounts charged as an expense for management services provided by such entities.

IAS 36, 'Impairment of assets'

The disclosures required when there has been a material impairment loss or reversal in the period are the same whether the recoverable amount has been estimated using 'value in use' or 'fair value less costs of disposal'.

IFRS 8, 'Operating segments'

Entities are required to disclose the factors used to identify the reportable segments when operating segments have been aggregated. The reconciliation of a segment's assets to the entity's assets is only required when details of segment assets are reported to the chief operating decision-maker.

Draft IFRIC on levies recognised at certain point in time

The IFRS Interpretations Committee has published an exposure draft on the accounting for levies charged by public authorities on entities that operate in a specific market.

The proposed interpretation is expected to apply retrospectively but this date is not yet defined; early application is likely to be permitted.

The proposed interpretation addresses levies that are recognised in accordance with IAS 37, 'Provisions, contingent liabilities and contingent assets'; it does not apply to income taxes within the scope of IAS 12, 'Income taxes'. The interpretation focuses on:

- the definition of a present obligation; and
- when the liability to pay a levy should be recognised.

Entities that are subject to levies for operating in a specific market such as a specific country, a specific region or a specific market in a specific country might be affected. These levies are common in many industries – for example, banking.

Management should evaluate the accounting for any levies that might be in the scope of the proposals. Management should also consider commenting on the exposure draft. The deadline for comments is 5 September.

Draft IFRIC to change measurement of NCI puts

Put options written on non-controlling interests (NCI puts) are contracts that oblige a parent to purchase shares of its subsidiary that are held by a non-controlling-interest shareholder for cash or another financial asset. IAS 32 para 23 addresses initial measurement; it requires management to recognise a financial liability for the present value of the redemption amount in the parent's consolidated financial statements.

There is currently diversity in how entities subsequently present the changes in the measurement of NCI puts. The draft interpretation requires the changes to the financial liability to be accounted for in the income statement.

The key clarifications in the draft are:

- Subsequent measurement of NCI puts should be in accordance with IAS 39/ IFRS 9, which require changes in the measurement of the financial liability to be recognised in the income statement.
- Subsequent measurement of NCI puts does not change the relative interests in the subsidiary that are held by the parent and the NCI shareholder; they are not therefore equity transactions.

All entities with NCI puts that are accounting for subsequent measurement of the financial liability in equity will be affected by the proposed changes. The deadline for comments is 1 October 2012.

In and out at IASB and IFRS IC

Martin Edelmann

Chungwoo Suh

Two new members have been appointed to the **IASB** for three-year terms from next month. **Martin Edelmann** was a member of the German Accounting Standards Board from 2006 until 2011. He was Head of Group Reporting at Deutsche Bank from 1997 to 2011. Before this, Mr Edelmann worked at KPMG and was a member of the Accounting Working Group of the German Banking Association for 14 years including as Chairman.

Chungwoo Suh was an advisor to the Korea Accounting Standards Board and is a Professor of Accounting at Kookmin University in Seoul. He served as Chairman of the KASB between 2008 and 2011, during which time he led Korea's preparations to adopt IFRS from 2011.

Two new members have been appointed to the IFRS IC. **Sandra Peters** is Head of Financial Reporting Policy with the CFA Institute in the US. Before this, she was a vice-president at insurance provider MetLife. She is also a former KPMG partner.

John O'Grady joins the IFRS IC from Ernst & Young, where he has been the Asia-Pacific IFRS Leader since July 2010. From 2005-2010, he led the Oceania Area IFRS Group. John is also a member of EY's global IFRS Policy Committee.

They will serve three-year terms, renewable once. They replace **Ruth Picker** and **Sara York Kenny**, whose terms expired this month. **Kazuo Yuasa** and **Laurence Rivat** will complete their first terms at the end of June 2012 and have been reappointed for a further three-year term.

IFRS quiz: impairment of assets

In this latest instalment of our IFRS quiz, impairment specialist Akhil Kapadiya tests your knowledge of IAS 36. You might also want to read our topic summary on impairment of assets to improve your chances of a good score.

Q1: What is a cash-generating unit (CGU)?

(a) Each individual asset.

(b) A group of assets such as a fleet of delivery trucks that are used to support other assets that generate cash inflows.

(c) The smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets.

Q2: Which of the following is correct in relation to the cash flow forecasts for calculating the value in use of a CGU under the value-in-use (VIU) method?

(a) Expenditure that replaces or restores separate components of a CGU that have shorter useful lives than the rest of the CGU can be included in the forecasts.

(b) Cash flows for future expenditure to enhance an asset's performance and the related benefits can be included in the forecasts.

(c) Neither of the above.

Q3: IAS 36 lists eight indicators of impairment, four external and four internal. Which of the following statements is true?

(a) Two or more indicators mean that an impairment test is required.

(b) At least one internal and one external indicator must be present before an impairment test is required.

(c) If no indicators from IAS 36 are present, no impairment test is required other than the annual test for goodwill and indefinite lived intangible assets.

(d) None of the above.

Q4: Which of the following statements is true when considering the discount rate for computing the present value of cash flows under FVLCTS and VIU?

(a) The weighted average cost of capital of an entity is always the best rate to use.

(b) The discount rate should only reflect the time value of money.

(c) The discount rate should reflect the time value of money and the risks specific to the CGU for which the future cash flow estimates have not been adjusted.

Q5: How is goodwill allocated to CGUs or groups of CGUs for purposes of impairment testing?

(a) Goodwill is allocated to those CGUs that represent the lowest level within the entity at which management monitors goodwill for internal purposes. The group of CGUs cannot be larger than a reportable segment.

(b) Goodwill is allocated to CGUs that represent the lowest level within the entity at which management monitors goodwill for internal purposes. The group of CGUs should not be larger than an operating segment before aggregation.

(c) Goodwill is tested separately for impairment and is not allocated to CGUs.

Q6: How is an impairment loss attributable to a CGU allocated to its components?

(a) The impairment loss is first allocated to write down goodwill and then the other assets of the CGU, within the scope of IAS 36, pro rata to the carrying amount of each asset in the CGU in the scope of IAS 36.

(b) The impairment loss is first allocated to write down all of the intangible assets and then the other assets of the CGU pro rata to the carrying amount of each asset in the CGU.

(c) The impairment loss is allocated to all assets of the CGU in the scope of IAS 36 (tangible, intangible, goodwill) pro rata to the carrying amount of each asset in the CGU.

Q7: Which of the following statements is true in relation to testing a brand for impairment?

(a) A brand is tested independently for impairment.

(b) A brand is tested for impairment along with other related assets that generate cash inflows.

(c) Any impairment of the CGU that contains a brand asset is first allocated to the brand and then to the other assets of the CGU on a pro rata basis based on carrying amount of each asset in the CGU.

Q8: Which of the following statements is false?

(a) Goodwill and indefinite lived intangible assets are tested once a year and when there are indicators of impairment. Other assets in the scope of IAS 36 are tested only when there are indicators of impairment.

(b) Impairment tests are required for all assets and CGU's only when there are indicators of impairment.

(c) Impairment tests on goodwill and intangibles may be performed at any time in the financial year provided that the tests are performed at the same time each year.

Q9: Which of the following statements is true in relation to determining the carrying value of a CGU?

(a) The carrying value of a CGU includes (is reduced by) the liabilities of the CGU.

(b) The carrying value of a CGU only includes the assets of the CGU and excludes (is increased by) the related liabilities of the CGU.

(c) It depends on management's view of the recoverable amount of the CGU. If management measures performance using net information, the carrying amount of the CGU should also be net of liabilities.

Q10: Which of the following statements are true in relation to determining the FVLCTS of a CGU?

(a) A different discount rate will be used to determine FVLCTS and VIU.

(b) FVLCTS is a preferred method of determining the recoverable amount than value in use under IAS 36.

(c) The difference between FVLCTS and the value in use arises because different cash flows are used.

Answers

Question 1: C – IAS 36 requires assets to be tested at the lowest level of separately identifiable cash inflows – generally a group of assets described as a 'cash-generating unit'. A is incorrect, as it is rare that an individual asset will generate cash flows on its own. Assets used to support other CGUs, such as delivery trucks for retail stores, will not generate identifiable cash inflows. These assets provide benefits to more than one CGU and are tested with the relevant group of CGUs.

Question 2: A – IAS 36 provides for two methods to calculate the recoverable amount of a CGU; fair value less costs to sell (FVLCTS) and value in use (VIU). The VIU methodology is more prescriptive and is intended to test the CGU as it exists today; it therefore includes only expenditure that would maintain the existing capacity of the CGU. FVLCTS is based on a market participant approach and can be estimated using assumptions that a market participant might make about enhancing the performance of a CGU. Any cash outflows related to enhancing performance and cash inflows from increased sales or decreased costs are excluded from a VIU calculation.

Question 3: **D** – The presence of any of the indicators of impairment should result in the performance of an impairment test. If there are contrary indicators (that is, financial or performance improvements), there is unlikely to be an impairment following the test, but testing is required. The list provided in IAS 36 is not exhaustive, and management needs to consider other indicators specific to their circumstances.

Question 4: **C** – A cash flow model is likely to be used to determine the recoverable amount under both the VIU and FVLCTS approaches. Selection of a discount rate is a key judgement. The discount rate for a VIU calculation should be a pre-tax rate that reflects the specific risks of the asset or CGU. A FVLCTS calculation would use a post-tax rate. Weighted average cost of capital (WACC) is a post-tax rate that reflects the risks of the entire entity. WACC can be a starting point for determining an appropriate discount rate for the specific CGU or groups of CGUs being tested for impairment. The risk that cash flows will be different from those included in the model should be incorporated in the model or in the discount rate; the rate used will therefore be different from WACC.

Question 5: **B** – Goodwill does not generate cash flows independent from other assets or groups of assets; it should therefore be tested with a CGU or group of CGUs to which it contributes. This should be at the lowest level at which goodwill is monitored by management but in any case no larger than an operating segment.

Question 6: **A** – An impairment loss arising in a CGU or group of CGUs is allocated to reduce the carrying amount of any goodwill first, then assets within the scope of IAS 36 pro rata to the carrying amount of the assets. Each asset is reduced to the higher of FVLCTS, VIU or nil until the impairment loss has been absorbed.

Question 7: **B** – A brand almost always generates cash flows in conjunction with other assets. For example, a branded consumer product commands a higher price than a generic product. A brand might be held only for royalty income but this is rare. The brand should therefore be tested with the assets to which it provides benefits.

Question 8: **B** – Indefinite lived intangible assets and goodwill must be tested annually and whenever there are indicators of impairment. The annual impairment test can be carried out at any time during the year; however, that test should take place at the same time every year. The requirement to test goodwill annually means that the CGU or groups of CGUs to which the goodwill is allocated should also be tested. Other assets in the scope of IAS 36 are tested only if there are indicators of impairment.

Question 9: **B** – The carrying value of a CGU excludes almost all liabilities, as liabilities consume rather than generate cash. Only liabilities that cannot be separated from the asset – such as a decommissioning provision for a nuclear power plant – are included in the carrying value of a CGU. If such liabilities are included, the cash flows related to the liability need to be adjusted (excluded from the cash flows) accordingly.

Question 10: – **A and C**. VIU is calculated using pre-tax cash flows and a pre-tax discount rate. FVLCTS is almost always calculated using post-tax cash flows and a post-tax rate; the discount rate is therefore expected to different. There is no preferred method of calculating the recoverable amount. If one method results in a recoverable amount below carrying amount, the other method is used as well to ensure that the impairment charge is based on a recoverable amount that is the higher of FVLCTS and VIU. The cash flows used under the two models are expected to be different; VIU tests the current productive capacity of the asset or CGU. FVLCTS can include cash flows to enhance or change the asset and related cash flow improvements if a market participant would undertake those enhancements.

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