IFRS News

Shedding light on the IASB's activities*

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Standard setting in an age of complexity

Key figures from the standard setting and regulatory communities met at the Global Public Policy Symposium last month to debate the benefits of principles-based accounting standards. Dick Kilgust, PwC global regulatory partner, acted as moderator at the Symposium. In this article he provides background to the event and gives an update on the views of panellists Sir David Tweedie, Bob Herz, and Conrad Hewitt.

A growing dialogue has developed in recent years about the future of financial reporting – and in particular the relevance and complexity of today's reporting model. PwC and the other large accounting firms have engaged in discussions with stakeholders around the world on a number of issues critical to the long-term strength and stability of the capital markets, including financial reporting.

These discussions have indicated overwhelming support for IFRS as a single set of high-quality accounting standards that can be used around the world. Stakeholders indicated their support for IFRS in part because it is perceived as more principles-based than US GAAP. There was, however, a lack of consensus on the key characteristics of principles-based standards.

As a contribution to the debate, the large firms published a White Paper *'Principles-Based Accounting Standards'* to coincide with the Global Public Policy Symposium hosted by the firms in New York. The paper proposes a framework to use in developing principles-based standards and suggests changes needed on the part of participants in the financial reporting process to support such a system.

It is acknowledged in the paper that neither a purely rules-based nor a purely principles-based system has ever existed, or will ever exist. Each accounting standard will exist somewhere along a spectrum between rules and principles. The goal must be to seek the "sweet spot" on that spectrum. Many commentators argue that, today, we are too skewed towards the rules-based side of the spectrum and the focus should be on pushing the pendulum towards a system which would enable principles-based standards and a greater use of judgement to become the norm.

The White Paper proposes six characteristics which the firms believe are the key elements of a high-quality, principles-based accounting standard:

1. Faithful presentation of economic reality
2. Responsive to users' needs for clarity and transparency
3. Consistency with a clear Conceptual Framework
4. Based on an appropriately-defined scope that addresses a broad area of accounting
5. Written in clear, concise and plain language
6. Allows for the use of reasonable judgment.

While each of the six characteristics is fundamental to the success of any principle-based system, the first two are regarded as pre-eminent. The need for them should be self-evident. Indeed, the whole purpose of requiring companies to publish audited financial statements is to provide investors with a tool to gauge economic and management performance and prospects. Yet the reality is that under today's accounting this goal is often not met. Companies can comply with the strict letter of the requirements, yet may fail to provide the information that provides a clear picture of the economic state of the enterprise.

The firms' paper was discussed by a panel at the Symposium comprising Sir David Tweedie and Bob Herz, respective chairmen of the IASB and FASB, and Conrad Hewitt, Chief Accountant at the US Securities and Exchange Commission.

The panel participants welcomed the paper, while noting that similar papers have been prepared by other organisations in the past. They identified key issues as being those of comparability and the exercise of judgment. Bob Herz commented "We need to flush out the comparability issue. Regulators have tended to believe in the need for comparability and this may have contributed to the model we have today." Sir David agreed "The minute that users and regulators want things to be comparable, the standards have to be longer. We could provide a financial instruments standard that is two paragraphs long, but the existing standards are full of exceptions."

Both standard-setters also agreed on the need for all involved in financial reporting to respect the exercise of reasonable judgment. Sir David noted "Principles-based standards can fail if not applied in a spirit of integrity. At the same time, preparers and auditors should not ask for voluminous interpretations, and regulators need to avoid 'second-guessing'". Conrad Hewitt added his own advice that "The IASB needs to defend itself against every request for guidance."

The White Paper sets out the changes that different groups will have to consider to ensure successful implementation of a system of principles-based standards. Preparers of financial statements will need to put more emphasis on the exercise of professional judgment to faithfully report the economic substance of their enterprise. The financial reporting process will be less driven by seeking to identify the rule that directs how to record a transaction or make a disclosure, and will place more emphasis on the exercise of judgment. Regulators should focus on the soundness of the underlying judgments that are the very essence of good business reporting and external auditing.

The audit profession, for its part, should continue to act in investors' interests and provide reasonable assurance that the financial statements are fairly stated in accordance with the standards. That is true today. It will be all the more critical as we shift to a more principles-based system that relies on sound professional judgment and where clarification cannot constantly be sought from the standard setter.

Looking back on the White Paper and the Symposium discussion, I believe the important thing is how we now take this debate forward. We are not talking about the standards that will be issued tomorrow, but how the standard setting process will evolve and the standards that might be issued in five or ten years time. We should hold the standard-setters to these principles as we assess their proposals in the years to come. And, at the same time, we as auditors need to avoid continually asking for more guidance and interpretation.

The White Paper *'Principles-Based Accounting Standards'* can be obtained from the Symposium website **www.globalpublicpolicysymposium.com**

Amendment to IFRS 2 dealing with vesting conditions and cancellations

The IASB published an amendment to IFRS 2 Share-based Payments, on 17 January 2008. Richard Davis looks at the changes and their impact.

The amendment to IFRS 2, *Share-based Payments* dealing with vesting conditions and cancellations has been issued after a long gestation period. The exposure draft appeared in spring 2006. The amendment limits vesting conditions to service conditions and performance conditions. Other features of a share-based payment are not vesting conditions. These features are included in the grant date fair value for share based payment transactions. That is, these features will not impact the number of awards expected to vest or their valuation subsequent to grant date, but only impact the grant date fair value.

The amendment also specifies that all

cancellations, whether by the entity or by other parties, should receive the same accounting treatment, ie acceleration of the expense based on the grant date fair value.

These changes will have an impact on the accounting for share-based payments which include conditions unrelated to service, especially those which an employee can choose to meet or not. Common examples will be awards which include a condition that the employee must hold a number of shares or awards linked to savings plans.

Consider an example where employees agree to invest 100 per month for 5 years in a savings vehicle. The vehicle guarantees interest of 180, payable at the end of the 5 years. The employee can take the accumulated savings at any time, but will only get the interest if he completes the full 5 years. An employee that remains with the company and continues to make investments can use the accumulated fund of 6,180 [(100 x 12 x 5) + 180] to purchase shares at an exercise price of 80% of the share price at the start of the savings period.

Applying the amendment to IFRS 2, the requirement to stay with the company will be a vesting (service) condition and the requirement to invest will be a non-vesting condition. This means that the grant date fair value for the IFRS 2 expense must include the effect of employees choosing to give up their options by stopping saving. This is a separate assessment from any assumption regarding employee turnover. If employees do stop saving this will lead to an acceleration of expense recognition but there will be no truing up for any variation between actual experience and the assumptions used in calculating the grant date fair value.

This may seem relatively straightforward at first glance, even though it may lead to a quite volatile expense. If past experience indicates that 25% of employees stop saving whilst still working then don't we just reduce the value of the option by 25%?

Unfortunately it is not that simple. Some employees will decide to stop saving for factors that are unrelated to the share price; they may have other obligations or other investment plans. This introduces an element of economically irrational behaviour that must be incorporated in the grant date fair value. Other employees may stop saving because the option is underwater and they see no value in continuing to save. If the only circumstance in which employees ceased saving was when the option had no value it would have no impact on the determination of the fair value of the options.

Applying these provisions in practice will need judgement. It is important that preparers start to gather the data to support those judgements sooner rather than later.

The amendment will apply for annual periods beginning on or after 1 January 2009, with earlier application permitted.

Annual Improvements Project – minor change or major overhaul?

Avni Mashru, senior manager in PwC's global accounting consulting services group, explains the scope of the proposed amendments in the IASB's 'Improvements' project, and gives PwC's views on the proposals.

The IASB published its first annual 'Improvements' exposure draft in October 2007. The project aims to provide an efficient process for addressing a number of minor, yet essential, changes to existing standards that may not warrant separate exposure drafts on a stand-alone basis.

The exposure draft proposed 41 amendments affecting 25 standards – illustrating the far-reaching scope of the project. The amendments proposed varied from a substantive change to the definition of a derivative, to minor amendments to provide consistency of terminology used in the standards. 41 seems a large number for improvement annually. Observers hope that the number represented a 'backlog' of minor amendments that had accumulated for this project. That aside, did the exposure draft stick to its advertised scope?

PwC's comment letter to the Board expressed overall support for the project's objectives. However, it raised concern that six of the proposed amendments fell outside the scope of the project. These six seem important enough to warrant debate on a separate basis.

One of the most notable of these relates to IAS 1, *Presentation of financial statements*. A proposed amendment to this standard introduces the requirement to make additional disclosure where an entity is unable to make an explicit and unreserved statement of compliance with IFRS. This would be the case where, for example, an entity has applied IFRS as adopted by the EU and differences result from full IFRS. Such disclosure would have to qualitatively describe each difference between the basis used and IFRS, and how the reported financial position and performance would have differed had full IFRS been applied.

The disclosure might provide valuable information to users of financial statements. However, it might prove impossible to operationalise without the cooperation of the global regulatory community and the auditing profession. For example, a jurisdiction could simply 'carve out' the text from the version of standard that it endorsed or adopted thus creating a circular problem. Thus, this amendment does not seem to fall into the category of an annual improvement.

A further amendment that seems to be outside the scope of an annual improvement is the proposed change in the definition of a derivative under IAS 39. The definition of a derivative currently excludes contracts whose values change in response to a non-financial variable and that variable is specific to a party to the contract. The amendment proposes to remove the exclusion with respect to non-financial variables, resulting in these contracts being classified as derivatives with measurement at fair value. This would affect a wide range of contracts such as loans where the interest payable varies dependent on the performance of the borrower, or lease contracts where payments are linked to performance measures specific to the lessee.

This proposal could well have the substantive result of an entity having to fair value its own business risk or its own future profit streams. This seems a substantive conceptual change in accounting for derivatives. Accounting for these contracts under the current version of IAS 39 provides a better measure of changes in the contract’s value rather than fair value measurement.

Four additional amendments appear as if they might have a similar significant impact if they were implemented as drafted. These are: the change to IFRS 5 involving classification of a subsidiary's assets and liabilities when a sale plan with a loss of control is in place; the amendment to IAS 16 (and consequentially to IAS 7) with respect to assets held for rental; the change to IAS 19 in respect of entitlement to benefits and the amendment to IAS 38 with regard to costs of advertising and promotional expenditure. A challenge for the Board to take forward to the next project is to draw the distinction between minor and significant amendments. Significant amendments deserve a comprehensive debate.

ED amendments to IFRS 1 and IAS 27

The IASB released a second exposure draft (ED) last month proposing amendments to IFRS 1, First-time Adoption of International Financial Reporting Standards and IAS 27 Consolidated and Separate Financial Statements. The proposed amendments provide relief from certain requirements in the separate financial statements of a parent. Michelle Orozco of the Global ACS Central team explains the proposals.

There are two particular challenges for parent companies adopting IFRS, using the existing IAS 27, in their separate financial statements:

- If management applies a policy of carrying a subsidiary at cost (as opposed to fair value), that cost is determined in accordance with IFRS. Cost determined under previous GAAP may not be consistent with IFRS and recreating this cost basis could be impracticable.

- Dividends received by a parent company are split between those arising from pre- and post-acquisition profits. The former are credited against the investment; the latter are recorded in income. A parent company would have to assess whether it had ever received a distribution out of a subsidiary’s pre-acquisition profits as part of calculating the restated cost of investment under IAS 27.

The Board issued an ED in January 2007, giving some relief for these issues, and received 47 comment letters. The Board has decided to amend its original proposals as well as suggesting two further changes based on respondents’ comments. Given the significance of the further changes, it has re-exposed the proposals.

Amendments to IFRS 1 (amended proposals):

- An entity may use either the fair value in accordance with IAS 39 or the previous GAAP carrying amount as deemed cost for an investment in a subsidiary on transition to IFRS. The Board had previously proposed fair value or a net asset value. Respondents felt that net asset value could be difficult to apply and was no less arbitrary than a previous GAAP amount. The Board has amended its proposals, removing the net asset option and allowing a previous GAAP carrying amount. A similar exemption for consolidated financial statements was already given for business combinations occurring prior to transition.

- This exemption is extended to investments in associates and joint ventures in the separate financial statements at transition date.

Amendments to IAS 27 (new proposals):

- The definition of the ‘cost method’, which requires dividends to be split between pre- and post-acquisition, is deleted from IAS 27.
- Investors should recognise as income all dividends received from

a subsidiary, jointly controlled entity or associate in their separate financial statements.
- The receipt of dividends would require investors to test the related investment for impairment in accordance with IAS 36.

The changes to the cost method take a quite different approach to accounting for subsidiaries in separate financial statements. It is a simplification but it will require proper application of IAS 36 to ensure that income is not overstated.

The ED also considers the situation of a reorganisation within a group where a newly established entity is added to the top of a group to become the owner of an existing parent. The ED proposes that the new parent measures the cost of this investment using the carrying amounts of the equity, assets and liabilities in the separate financial statements of the previous parent at the date of the new parent's formation.

The scope of the amendment is narrow but it touches on other issues around separate financial statements, group reorganisations and other common control transactions.

Comments on the ED are due by 26 February 2008.

Exposures qualifying for hedge accounting (the 'Portions' ED)

The IASB published an exposure draft 'Exposures Qualifying for Hedge Accounting' in September 2007. Scott Bandura of the Global ACS Central team sets out the implications of the proposals and gives PwC's views on what is often referred to as the 'portions' ED.

What are Portions?

IAS 39 permits an entity to 'carve' a financial instrument into portions for hedging purposes and designate a portion of cash flows or fair value of an instrument as a hedged item. For example, designating only the LIBOR portion of a floating-rate debt that pays LIBOR plus a spread. Hedging a portion of a financial instrument can be useful because an entity can designate a portion that matches the risks that are hedged with a derivative. This helps to reduce ineffectiveness.

Reasons for the exposure draft

The IFRIC received a number of submissions requesting guidance on what qualified as a portion under IAS 39. Rather than answer each individual issue, the IFRIC sought to develop guidance on what IAS 39 meant by a "portion". The matter was referred to the IASB when the IFRIC failed to reach a conclusion.

The Board decided to develop detailed guidance to:
(i) specify the risks that qualify for designation as a hedged risk; and
(ii) provide additional guidance on what can be designated as a hedged portion in a hedging relationship.

The IASB stated its goal was to clarify its original intentions regarding what can and cannot be designated as a hedged item, rather than to change existing practice.

PwC's View

This seems to be a rules based approach for determining which portions may be hedged. We support a principles based approach as:
- IFRS is a principles-based set of standards;
- Principles are more consistent with the IASB's objective to simplify hedge accounting;
- Principles are more durable than rules and can be applied to new products and hedging strategies; and
- Rules lend themselves to structuring opportunities by reducing the opportunity to apply judgement

An alternative proposal

Our response letter proposed a set of principles that would permit flexibility in which portions were eligible for hedge accounting. These are:

Principles underlying portions
- A portion of the cash flows of a hedged item is a separately identifiable subset of the total cash flows of the hedged item
- A portion of the fair value of a hedged item is a separately identifiable component of the fair value of the hedged item that market participants could consider in determining the fair value of the instrument.

Principles underlying risks
- A risk eligible for hedge accounting must have a predictable and reliably measurable effect on the cash flows or fair value of the designated hedged item.

These principles satisfy one of the Board's key concerns – the ability to assess hedge effectiveness reliably.

Hedging Future Cash Flows Using Purchased Options

Companies commonly hedge one-sided risks. An entity that has floating LIBOR debt, for example, might

purchase an interest rate cap to mitigate risks of LIBOR increasing beyond a certain level. This is a one-sided risk as the entity will not suffer if interest rates fall. An entity that has forecast future sales in a foreign currency might purchase a foreign currency option to mitigate the risk of the currency moving against the entity.

IFRIC was asked whether (in a hedge of one-sided risk), it is possible to designate the hedged item as a hypothetical written option (using what is commonly called a 'hypothetical derivatives' method to designate the hedged risk and test effectiveness). The IFRIC tentatively concluded that IAS 39 does not permit such an approach and published a tentative agenda decision to this effect. This was later withdrawn pending the publication of the Board's exposure draft on portions, which attempts to confirm IFRIC's previous decision.

PwC's View

We support use of the hypothetical derivatives method in assessing effectiveness of options based hedging strategies for both financial and non-financial hedging relationships.

The ED's basis for conclusions indicates that its guidance will only apply to financial items. However, option based hedging strategies are common for non-financial hedging relationships such as hedges of forecast foreign currency sales with currency options. The Board may have intended to prohibit use of the hypothetical derivative method in non-financial hedging relationships. However, the modifications to the standard as currently drafted do not achieve that goal.

Transition

The exposure draft proposes retrospective application of the changes to the standard.

PwC's View

The transition requirements should be consistent with past changes to the hedging guidance in IAS 39. That is, the standard should require redesignation on the transition date and allow continued deferral of existing amounts in equity that were recognised prior to the change in the standard.

IFRIC 12 – the political debate

The IFRIC published IFRIC 12 *Service Concession Arrangements* in November 2006. Global ACS partner Peter Hogarth explains the implications for entities operating in the EU.

IFRIC 12 addresses the accounting by private sector operators in public-to-private service concession arrangements. It is effective for periods beginning on or after 1 January 2008.

IFRIC 12 introduces significant changes to ways in which many operators currently account for service concession arrangements. The Interpretation requires that infrastructure constructed or upgraded as part of a service concession arrangement is accounted for as either a financial asset or an intangible asset. An operator recognises a financial asset to the extent that it has an unconditional contractual right to receive cash or another financial asset from or at the direction of the grantor. An operator recognises an intangible asset to the extent that it receives a right (a licence) to charge users of the public service.

IFRIC 12 is not new, so why is it newsworthy now?

European listed groups are required to prepare their consolidated financial statements using 'IFRS as adopted for use within the European Union', meaning that standards issued by the IASB need to be 'endorsed' before they can be used within the European Union. IFRIC 12 has not yet been endorsed and there are signs that endorsement should not be assumed.

Some starkly opposing views were expressed at the November meeting of the European Commission's Accounting Regulatory Committee. One member argued that IFRIC 12 should be considered a temporary solution to the problem of accounting for service concession arrangements and that the Commission should continue to work with the IASB towards finding a more acceptable solution. Another member argued for a quick endorsement.

The European Commission has initiated an effect analysis on IFRIC 12 as input to the endorsement process. The analysis takes the form of a short questionnaire, similar to that undertaken for IFRS 8 prior to its endorsement in November 2007. The Commission is interested in the views of users of financial statements as well as the operators themselves. The deadline for comment was 25 January 2008 and it will be interesting to see whether respondents are concerned more about the specifics of IFRIC 12 or the benefits of aligning EU-endorsed IFRS and IFRS as issued by the IASB.

What are the implications for a European entity that wants to apply IFRIC 12 before it is endorsed?

The IFRIC's role is to interpret standards and issue interpretations that fill gaps between standards. It cannot by itself issue or amend standards. This means that, unless an IFRIC interpretation is accompanied by a consequential amendment to a standard, it may be used independently of the endorsement process. However, IFRIC 12 did contain consequential amendments (to the scope of IFRIC 4 *Determining whether an Arrangement contains a Lease* and to the disclosures required by SIC 29 *Disclosure – Service Concession Arrangements*). Whilst additional disclosure may enable an entity to comply with SIC 29's requirements both before and after its amendment, the lack of endorsement for the amendment to IFRIC 4 is more problematic. Many service concession arrangements currently fall within the scope of IFRIC 4 and the accounting treatment may be quite different until such time as the arrangements are taken outside its scope.

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