

IFRS news

Emerging issues and practical guidance*

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Financial instruments accounting takes another step forward

Standard setters continue their work on FI accounting in response to the financial crisis. The FASB has released its long-awaited comprehensive ED on accounting for FI. The IASB continues its topic-specific approach, releasing its proposal for accounting for financial liabilities. Elizabeth Lynn of PwC's Accounting Consulting Services central team looks at the detail of the proposals.

Where are we now?

Both boards have undertaken a comprehensive review of financial instrument accounting. The IASB is approaching its project in phases: classification and measurement, impairment and hedging. The IASB's proposals for changing the accounting for financial liabilities were contained in the May 2010 exposure draft 'Fair value option for financial liabilities'. The IASB has already published guidance on accounting for financial assets, in IFRS 9, 'Financial instruments', in 2009.

The IASB proposals on impairment and interest recognition are different from those of the FASB.

The FASB's proposal includes classification and measurement, impairment and revisions to hedge accounting. It also proposes extensive new presentation and disclosure requirements. The IASB and FASB are working on these projects at the same time, so the FASB proposals may impact the IASB's deliberations.

Financial liabilities – IASB

The classification and measurement of financial liabilities under IFRS will remain the same except where the financial liabilities are designated at fair value through profit or loss (FVTPL). Existing requirements for liabilities are generally seen to work well, and none of the alternative approaches considered by the IASB would be less complex or provide more useful information.

The only proposed change in accounting is for entities with financial liabilities designated at FVTPL. First, all changes in fair value of the financial liability would be recognised in the profit or loss. Second, the change in value due to changes in the liability's credit risk would be recognised in other comprehensive income (OCI) with an offsetting entry to profit or loss.

The main concern regarding liabilities is the impact of 'own credit' for liabilities recognised at fair value – that is, fluctuations in value due to changes in the liability's credit risk, in the

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income statement. This can result in gains being recognised in income when the liability has had a credit downgrade, and losses being recognised when the liability's credit risk improves. Many users find this result counterintuitive, especially when there is no expectation that the change in the liability's credit risk will be realised.

Financial liabilities that are required to be measured at FVTPL (as distinct from those that the entity has chosen to measure at FVTPL) will continue to have all fair value movements recognised in profit or loss with no transfer to OCI. This includes all derivatives, such as foreign currency forwards or interest rate swaps, or a bank's own liabilities that it holds in its trading portfolio.

FASB proposals

The FASB has published significantly different proposals from the IASB on financial instrument accounting in its proposed Accounting Standards Update, 'Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities'. The more significant difference relates to the classification and measurement approach for financial assets. IFRS 9 requires amortised cost measurement for certain financial instruments; versus a proposed fair value through 'other comprehensive income' approach under US GAAP.

Classification and measurement

The FASB proposes that most financial instruments should be measured at fair value, except for core deposit liabilities of financial institutions, which would be valued using a new remeasurement methodology. Trade receivables and payables may be recognised at amortised cost if certain criteria are met. All changes in fair value would be recognised in net income unless an instrument qualifies and the entity elects to recognise those fair value changes in OCI. The determination of whether an instrument qualifies for OCI treatment focuses on an entity's business strategy and the instrument's characteristics. There will also be a limited exception that allow certain financial liabilities to be recognised at amortised cost.

Impairment

Financial assets for which OCI treatment or amortised cost is elected would be subject to a single credit impairment model. A credit impairment would be recognised in net income when an entity does not expect to collect all of the contractually promised cash flows. An entity would no longer wait for a probable event before recognising a loss.

Hedge accounting

Hedge accounting would be available for financial instruments where OCI or amortised cost treatment has been elected. The risks that are eligible for hedge accounting would remain unchanged. However, it would be easier to qualify for hedge accounting because a hedging relationship would only need to be reasonably effective (no longer highly effective).

Am I affected?

The IASB proposals impact entities that have designated financial liabilities at fair value through profit or loss. For example, they will impact financial institutions that have designated liabilities at FVTPL to eliminate an accounting mismatch with financial assets that are held at FVTPL, or to avoid bifurcating an embedded derivative.

If the proposals are agreed, they will be applicable for financial periods beginning on or after 1 January 2013.

The FASB proposals will affect entities applying US GAAP across all industries that hold or issue financial instruments and that apply hedge accounting. Financial institutions (especially retail and commercial banks) are likely to be most significantly impacted by these changes.

What do I need to do?

The comment period for the IASB exposure draft closes on 16 July 2010. The FASB comment period closes on 30 September 2010. We encourage management to reply.

'Investor view' – insight from the investor community

PricewaterhouseCoopers' 'Investor view' series provides preparers of IFRS financial statements with insight gleaned from our ongoing dialogue with the investment community. It highlights the financial reporting areas of most interest to analysts and investors with the aim of helping preparers improve their communication to the capital markets.

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- Investors look for improvement in reporting of non-GAAP measures

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Cannon Street Press

IASB proposes single statement of comprehensive income

What is the issue?

The IASB has published an exposure draft that would require all entities to present a single statement of comprehensive income. This amendment to IAS 1, 'Presentation of financial statements', will eliminate the option in the existing version of the standard to present a separate income statement. The proposals have been developed jointly with the FASB, which has issued a similar proposed amendment to US GAAP.

The proposals retain the concept of net profit, but entities will also be required to present total comprehensive income on the face of the single performance statement. Sub totals for net profit or loss and other comprehensive income (OCI) will be presented as separate sections of the single statement of comprehensive income. Earnings per share will continue to be based on net profit or loss.

The proposals make no change to the items that are presented in net profit or loss and OCI, and the option to report the components of OCI either gross or net of income tax will be retained. Items included in OCI that may be recycled into profit or loss in future periods (for example, cash flow hedges and the cumulative translation adjustment) will be presented separately from those that will not be recycled (for example, revaluations of property, plant and equipment, and actuarial gains and losses).

The title of the statement will change to 'statement of profit or loss and other comprehensive income'. However, the flexibility

to use other titles for the primary financial statements is retained.

Am I affected?

The proposed amendment will affect all entities and change the appearance of the performance statement. Entities that currently present a separate income statement will be required to prepare a single statement showing both net profit and OCI. Entities that currently present a single statement will be required to change the format of the OCI section to separate items that might be recycled from items that will not be recycled.

The measurement of net profit or earnings per share will not change, but these will be presented differently in the financial statements. Management should consider how this will be explained to investors and other users of the financial statements.

What do I need to do?

Comments on the proposals are due on 30 September 2010. The Board expects to finalise the amendment in the second half of 2010.

Management should consider whether to respond to the IASB. Management should also consider the implications of the proposed changes for the presentation of results and how this should be communicated to the users of the financial statements.

Global Communications GAAP Summit 2010

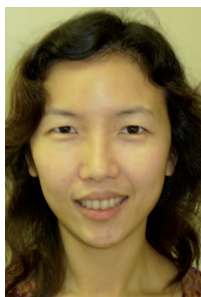
PwC's Global Communications Industry group is hosting the 7th annual Global Communications GAAP Summit. The Summit is a day-and-a-half event that focuses on changes and technical accounting issues occurring in the communications industry.

This year's event is being held in Madrid, Spain, with a theme of 'Ready for the next wave?'. The agenda focuses on the commercial, accounting and reporting issues that the industry will face with impending new standards, including pronouncements on:

- Revenue recognition – impact on key metrics and systems complexity?
- Leases – bad for gearing but good for EBITDA?
- Liabilities and provisions – a new layer of complexity?
- Joint ventures and consolidation – Potential for simplification?

We will also cover existing areas of GAAP that continue to pose questions for operators, including accounting for new service offerings, network and operational costs, and licences. Guest speakers from Deutsche Telekom, Telcom Italia and Telefónica will share their views on the industry and on some of the regulation that affects the communications sector. Over 100 people from operators around the world will attend.

Contact: paul.barkus@uk.pwc.com for more details.



Pre-implementation review of IFRS 3R

Shelley So of PwC's Accounting Consulting Services in Hong Kong looks at items under scrutiny in the IASB's pre-implementation review of the new business combinations standard.

IFRS 3 (revised 2008) (IFRS 3R) is the first 'official' converged standard between IFRS and US GAAP. The new standard has resulted in more earnings volatility – for example, expensing transaction costs, gain/loss in fair valuing the previously held interests and subsequent measurement of contingent consideration. Few preparers have adopted early, so 2010 is the first year most will adopt IFRS 3R and IAS 27R.

Unusually, amendments have been made that apply to IFRS 3R and IAS 27R before they were even effective. The IASB has received a number of requests for clarification and guidance since the standards were issued two years ago.

The IASB did not wait for a post-implementation review but has decided to look at some of the implementation issues earlier. These issues include transition arrangements, contingent consideration, non-controlling interests, implications for equity accounting and separate financial statements.

The Board and IFRIC have been discussing the implementation issues since May 2009. Four issues were included in the 2010 Annual Improvements, but other clarifications have come from IFRIC agenda decisions, *IASB Updates* and other guidance. Below is an overview of the issues that the Board and IFRIC have considered so far.

Transition arrangements

The Board looked at transition arrangements in a number of areas as described below:

- *Contingent consideration arising from business combinations whose acquisition dates preceded the adoption of IFRS 3R (pre-adoption contingent consideration).* The IASB has amended the IFRS 3R transition provisions and made consequential amendments to IFRS 7 and IAS 32 to clarify that pre-adoption contingent consideration has been grand-fathered (2010 Annual Improvements). The IASB has carried forward the IFRS 3 (issued 2004) requirements on accounting for contingent consideration into the transition provisions of IFRS 3R.

The amendment is effective for annual periods beginning on or after 1 July 2010. However, it requires retrospective application from the date when the entity first applied IFRS 3R. Entities should adopt the amendment at the same time as they adopt IFRS 3R.

The Board has not extended this exemption to first-time adopters. First time adopters that adopt IFRS 3R in their first IFRS financial statements should account for subsequent changes in contingent consideration in accordance with IFRS 3R, regardless of when the related acquisition happened.

- *Transition requirements for negative non-controlling interests.* IAS 27R requires losses to be allocated to the non-controlling interests (NCI), even if this results in NCI having a deficit balance. The Board clarified in its May 2009 meeting that upon transition, entities do not reallocate to the NCI previous losses that were attributable to NCI but were attributed to the parent's equity. Entities allocate subsequent total comprehensive income on the basis of the present ownership interests of the parent and NCI, prospectively from the adoption of IAS 27R.
- *Consequential amendments arising from IAS 27R.* Amendments have been made to IAS 21, IAS 28 and IAS 31 to clarify that entities should apply the consequential amendments arising from IAS 27R prospectively (2010 Annual Improvements).
- *Transaction costs.* An IFRIC rejection provides guidance on how an acquirer should account for the costs that it incurred before it applied IFRS 3R that relate to an acquisition to be accounted for under IFRS 3R upon transition.
- *Effective date for first-time adopters.* Clarification of the interaction between the effective date of IFRS 3R and IFRS 1. First-time adopters are not subject to the restriction on early application in IFRS 3R, as they should apply the same accounting policies for all periods presented.
- *Early application.* IFRIC rejection clarifying that the revised standard applies for the whole annual period if it is applied early.

Non-controlling interests

The change from minority interest to NCI was more than a change in name; it was also a change in definition. This change has widened the scope of instruments included in NCI – for example, options or warrants over an entity's own shares that are classified as equity and the equity component of a convertible instrument are now in NCI. The Board and IFRIC have addressed several NCI related issues in addition to the

transition requirement for negative NCI (above). These are considered below.

Measurement of NCI

IFRS 3R allows an entity to measure NCI either at its acquisition-date fair value or at the NCI's proportionate share of the acquiree's identifiable net assets. The Board confirmed in the 2010 Annual Improvements that such measurement choice is only applicable to present ownership instruments that entitle their holders to a proportionate share of the entity's net assets in the event of liquidation. All other components of non-controlling interests are measured at their acquisition-date fair values, unless IFRS requires another measurement basis. This might be, for example, IFRS 2 for the acquiree's employee share options. The Board has also included some illustrative examples in the annual improvement.

Un-replaced and voluntarily replaced share-based payment transactions

An acquiree's equity-settled share-based payment transactions are a component of NCI under the revised standards. IFRS 3R specifies the accounting for the acquiree's share-based payment transactions that the acquirer is obliged to replace or that expire as a consequence of the business combination. It is silent on the accounting for unreplaced or voluntarily replaced share-based payment transactions.

The Board has added additional guidance in this area in the 2010 Annual Improvements. It distinguishes the accounting treatment for transactions that expire as a result of the acquisition, which is recognised as post-acquisition expense, from those that do not expire in the event of a business combination – that is, NCI. The measurement of the replaced or unexpired share-based payment transactions is split between transferred consideration and post-combination expense.

Transaction costs for NCI

IAS 27R requires acquisitions and disposals of NCI that do not result in a loss of control of the entity to be accounted for as equity transactions. IAS 1 paragraphs 106(d)(iii) and 109 state that transaction costs related to transactions with NCI are not part of the income statement. The IFRIC therefore rejected a request to add the accounting of transaction costs for NCI to its agenda, confirming that the treatment of transaction costs for raising equity is clear.

Re-attribution of other comprehensive income (OCI)

The Board has confirmed that when there is a change in ownership interest in a subsidiary without loss of control – that is, an equity transaction – the parent re-attributes OCI between the owners of the parent and the NCI.

Interaction with financial instrument standards

The interaction between IFRS 3R and the financial instrument standards is intensified. Contingent consideration is now within the scope of IAS 39. Written puts over NCI, as well, continues to be a challenging area

Designation of contingent consideration

Neither IFRS 3R nor IAS 39 specifies the categories into which contingent consideration assets and liabilities are classified, although the guidance on measurement is explicit. Contingent consideration not classified as equity is generally accounted for as if it was a derivative in IAS 39. Changes in fair value are recognised in the income statement. However, IAS 39 (and IFRS 7) requires classification of financial assets and liabilities into categories for determining what disclosures are required of financial instruments. The Board in its May 2009 meeting decided to address this issue in the IAS 39 replacement project. The IFRIC has also recommended the Board bring together in one IFRS the measurement guidance for contingent consideration that is a financial instrument.

Classification of contingent consideration

The 'fixed-to-fixed' question arises when a contingent consideration arrangement is settled in an entity's own shares. IAS 32 allows equity classification only when an entity will settle the contracts by delivering a fixed number of its own shares in exchange for a fixed amount of cash or another financial asset. As the 'fixed-for-fixed' assessment is not unique to contingent consideration arrangements, the Board has decided that this issue should be addressed in the debt/equity project and not on a standalone basis for IFRS 3R.

Put options written over non-controlling interests (NCI put)

A parent company may enter into a commitment through a call option, a written put or a forward purchase to acquire shares in a subsidiary held by NCI. The initial and subsequent accounting for these instruments continue to challenge preparers and auditors.

The IFRIC has decided to add the accounting for puts over NCI to its agenda. Having observed that there is a potential conflict between IAS 32 and IAS 39, and the requirements in IAS 27R, the IFRIC will attempt to provide guidance in this area. The IFRIC staff will develop a paper for further discussion in its July 2010 meeting.

Interaction with equity accounting (IAS 28) and IAS 31

The revisions of IFRS 3 and IAS 27 have had an impact on the standards for equity accounting and joint ventures.

Significant economic event

The Board previously concluded that the loss of control of an entity and the loss of significant influence/joint control over an entity are economically similar events and should be accounted for in a similar manner. It therefore has revised the accounting for loss of significant influence/joint control in IAS 28 and IAS 31 as part of the consequential amendments of IAS 27R.

However, during recent deliberations of the joint venture project, the Board has tentatively decided to redefine 'significant event' in the context of loss of joint control and significant influence; and that a move from 'joint control' to significant influence is not a 'significant event'. The Board considers this change to be consistent with the conclusion that a retained interest is not re-measured when an entity has lost joint control but retains significant influence in an investee.

The Board has also tentatively decided that when an entity disposes of a partial interest in a joint venture or in an associate, it only reclassifies the interest it committed to dispose as held for sale; it continues to account for the retained interest using the equity method until the disposal occurs.

The impact of this Board decision is not limited to IFRS 5 and could be pervasive. Recently the Board tentatively decided to amend IAS 21, 'The effects of changes in foreign exchange rates', to treat the loss of joint control with the retention of a significant influence as a partial disposal instead of a disposal. The IFRIC will also reconsider a request to amend IAS 21 – 'Repayment of investment/CTA' – and has directed the staff to continue this analysis for future deliberation. It remains to be seen if there will be other implications from this Board decision.

Interaction with separate financial statements (SFS)

Many IFRS preparers look to the definition of cost of a business combination in IFRS 3 for guidance to measure the cost of investment in subsidiaries, associates and joint ventures in their SFS. This is partly because cost is not defined in IAS 27R, and many preparers believe that the initial measurement for the consolidated and separate financial statements should be the same. IFRS 3R eliminated the notion of the 'cost' of a business combination. It is unclear how the change from 'cost' to 'consideration' should impact the measurement of the cost of investment in the SFS, in particular with respect to contingent consideration, transaction costs and fair value adjustments.

The Board in its May 2009 meeting considered that a detailed review of these issues should be performed as part of the consolidation project. However, given the current scope of that project and the expected timing, it is unlikely that SFS issues will be addressed in the project.

Certain issues have already been identified as potential candidates for the post-implementation review. These include non-contractual customer relationships; whether indemnification assets are part of the business combination transaction or a separate transaction; and whether any diversity has appeared around 'what's a business'.

Convergence with US GAAP

The FASB has also been looking at early issues arising from the converged standards. Two issues have been discussed by the IASB as well: assumed contingent consideration arrangements and the meaning of 'subsidiary'.

Assumed contingent consideration of the acquiree

The FASB concluded that assumed contingent consideration retains its nature as contingent consideration under US GAAP and is measured in accordance with SFAS 141(R) (at fair value through profit and loss). The IASB in its June 2009 meeting clarified that assumed contingent consideration does not meet the definition of contingent consideration in the acquirer's business combination in accordance with IFRS 3R. Instead, it is one of the identifiable contractual liabilities assumed in the subsequent acquisition. However, because of the difference in the accounting for financial instruments under US GAAP and IFRS, treating it as part of the identifiable assets and liabilities of the acquiree or as contingent consideration will generally not have different accounting consequence under IFRS. This is because most contingent consideration obligations are financial liabilities within the scope of IAS 39. Accordingly, the Board did not add this item to the annual improvement project.

Meaning of a subsidiary

The FASB clarified that ASC 810 applies to the disposal of businesses that are not subsidiaries. The IASB considered the issues addressed by the ASU. It considered that the definition of a subsidiary included unincorporated entities and concluded that no further guidance was necessary.

Conclusion

The Board covered a wide range of issues at the pre-implementation stage of IFRS 3R, addressing some of the practical difficulties in implementation. Some issues remain and with the implementation of the revised standards this year, additional practical issues will continue to arise. The implementation of the revised standards is just the beginning of the journey.



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