

IFRS News

Shedding light on the IASB's activities*

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Issue of the month

Amendments to IAS 1

The IASB published Amendments to IAS 1, Presentation of Financial Statements in September, completing Phase A of the Board's joint project with the FASB. The changes align some aspects of IAS 1 with SFAS 130, Reporting Comprehensive Income. Michelle Orozco, from PwC's Global ACS central team, explains the key features of the amendment and its implications.

Implications

Transactions with owners are analysed separately from those relating to the performance of the entity. The user of the financial information will need to become familiar with understanding and explaining this new way of presentation.

The amendment defines 'owners' as being "the holders of instruments classified as equity". This definition also includes interests and is likely to include holders of compound financial instruments, such as convertible debt.

Those entities that have previously presented a separate statement of recognised income and expense (SoRIE) will now be required to provide in addition a statement of changes in equity. This will present information that has previously been provided in the notes. These entities can decide to make no change at all to the SoRIE or can elect to combine the SoRIE with the income statement into a single statement of comprehensive income. Entities are no longer allowed to present a statement of changes in equity that includes items of comprehensive income and changes due to transactions with owners.

The amendment considers aligning the comprehensive income concept with FAS 130; however, there are still some differences. For example, FAS 130 permits a third option of displaying comprehensive income in a statement of changes in equity. IAS 1 revised does not permit this third option. There are other items that are required by one standard but not the other. For example, the amendment to IAS 1 requires an entity to display the share of each item of associates' other comprehensive income; FAS 130 does not provide explicit guidance.

The amendments do not address a number of issues of practical application of IAS 1, such as the presentation of gains and losses of financial instruments. These may be dealt with in Phase B of the project, but the outcomes of Phase B are not expected for a number of years, and inconsistencies might still appear in the intervening period. It does, however, add some potential practical difficulties in estimating the tax effects of each item within comprehensive income.

The changes are likely to reduce comparability between entities because they allow choices in the presentation of financial information and in the names of the primary statements.

Next steps

The FASB did not publish a separate document considering Phase A of the project. It will expose its Phase A decisions along with its Phase B decisions.

Phase B

The Boards are jointly undertaking Phase B, which considers more fundamental questions, such as:

- consistent principles for aggregating information in each primary statement;
- the totals and subtotals that should be reported in each primary statement;
- whether the direct or the indirect method of presenting operating cash flows provides more useful information; and
- whether components of other comprehensive income should be reclassified to profit or loss and, if so, the characteristics of the transactions

and events that should be reclassified and when reclassification is made.

The IASB expects to publish a discussion paper early next year.

Phase C

Phase C will address presentation and display of interim financial information in

US GAAP. The IASB may reconsider the requirements in IAS 34, Interim Financial Reporting.

IAS 1 revised is effective for annual periods beginning on or after 1 January 2009. Early application is permitted. The revised IAS 1 resulted in consequential amendments to five IFRSs, 23 IASs and 10 interpretations.

Key changes to IAS 1

- Changes in equity arising from transactions with owners (such as dividends and shares repurchases) and the related tax impact are presented in the statement of changes in equity;
- 'Non-owner' changes in equity and the related tax impact are presented in comprehensive income*;
- Comprehensive income is presented in either a single statement or in two statements (an income statement and a statement of comprehensive income);
- Dividends and per share amounts are presented in the statement of changes in equity or in the notes;
- A statement of financial position (balance sheet) at the beginning of the corresponding period is presented where restatements have occurred; and
- Reclassification adjustments (recycling) and the related income tax are disclosed in the comprehensive income.

* Comprehensive income for a period includes profit or loss for that period and the components of 'recognised income and expense' previously reported in equity such as: changes in revaluation surplus; actuarial gains and losses on defined benefit plans recognised in equity; gains and losses arising from translating the financial statements of a foreign operation; gains and losses on remeasuring available for sale financial assets and; the effective portion of gains and losses on hedging instruments in a cash flow hedge.



Accounting issues arising from 'credit crunch'

Many people around the world are feeling the impact of a widespread shortage of liquidity and a widening of credit spreads. This 'credit crunch', which started by rising defaults in the US sub-prime markets, has led to significant volatility in the financial markets across the globe. Jessica Taurae of PwC's Global ACS central team explains some of the IFRS accounting implications.

Fair value

The recent illiquidity in some markets has led to difficulties in establishing the fair value of some financial assets and liabilities. The best evidence of fair value under IAS 39 is quoted prices in active markets. Where these are not available, entities use valuation techniques to estimate the fair value. A valuation technique must incorporate all factors that market participants would consider in setting a price. Determining fair value therefore requires consideration of current market conditions, including the

relative liquidity of the market and current credit spreads. Entities cannot ignore current information about how the market would price the instrument.

Impairment of financial assets

IAS 39 focuses on having objective evidence of impairment before a loss can be recognised. Companies will need to consider whether recent market conditions imply there is objective evidence of impairment for their financial assets. Loans to sub-prime customers or loans to other entities with sub-prime

exposures will probably have objective evidence of impairment as those customers default. However, if an entity has AFS debt securities whose fair value has decreased because of illiquidity and rising interest rates, that on its own is not considered objective evidence of impairment under IFRS.

Hedge accounting

Companies may be experiencing some hedge ineffectiveness as a result of recent market conditions. For example, if entities had designated fair value

hedges of fixed rate assets using interest rate swaps, ineffectiveness may arise due to the re-pricing of the floating leg of the swap. If entities had not designated their hedged risk carefully, they may have hedge ineffectiveness arising from changes in credit spreads that are not mirrored in the hedging instrument. Others that have hedged forecast debt issuances, including the rollover of commercial paper, will need to ensure that the hedged debt issuance is still highly probable of occurring. If not, the criteria for hedge accounting are no longer met, and the hedge accounting should cease.

Impairment of non-financial assets

The significant amount of M&A activity prior to the recent turmoil may well have resulted in significant amounts of

goodwill and intangible assets being recognised in acquiring entities' balance sheets. The recent volatility could impact impairment calculations in several ways, including triggering impairment reviews, affecting key assumptions (growth and discount rates) and requiring more sensitivity disclosures.

Pension valuations

The recent market conditions can have an effect on the value of both pension plan assets and plan liabilities. Pension plans may have invested in assets backed by sub-prime exposures; therefore, the value of their plan assets may have fallen. Looking at the liability side, one of the assumptions used in the projected unit credit method is a discount rate that references market yields. Given the volatility in the

markets, it is possible that those rates may have changed, although as yet there has been little impact on long-term rates.

Disclosures

The requirements in IAS 1 to disclose key sources of estimation uncertainty and significant accounting judgments, as well as the requirements in IFRS 7 regarding sensitivities to market risks, should provide readers with an interesting story about the way in which the company has been affected by the recent market conditions.

These are only some of the accounting areas preparers should bear in mind. Any accounting measurement that incorporates discounted cash flows is also likely to be affected by the recent market conditions.



Annual Improvements project

The IASB has published its first Annual Improvements exposure draft. The annual improvements process is designed to provide a timely and efficient way of making amendments to the IFRSs. The process is intended to address inconsistencies within or between standards and areas where the standards are unclear. Michael Stewart, member of PwC's Global ACS central team, was seconded to the IASB as project manager on the Improvements project. He explains the key changes.

There are 41 issues proposed for amendment in the ED, affecting 25 standards – some more than others. IAS 39 has five proposed changes, while none are proposed for IFRS 2. Some changes are intended to improve wording and are not expected to change the meaning of the standard. Others are clarifications that may result in changes to the way in which particular transactions or balances are accounted for by some companies. These companies may well find themselves with changes in accounting policy resulting from the amendments project.

The changes are not sweeping or conceptual in nature, but some may have significant measurement impact for

specific companies. The box below provides a list of those proposals that are expected to have a measurement impact for some entities.

Definition of a derivative

One of the more significant proposals is the intention to change the definition of a derivative. The current definition of a derivative excludes those for which the underlying variable is a non-financial variable specific to a party to a contract. An example is a lease contract in which the amount payable by the lessee is linked to the lessee's net income. This type of pricing formula is likely to qualify as an embedded derivative if the proposed amendment is made. The Board's proposal to delete this exemption within

the definition of a derivative will have the effect of requiring the items to be classified as derivatives and accounted for at fair value through income.

Recognition of prepayment for advertising costs

Another significant proposal is around prepayments for advertising expenditure. The proposal specifies that an entity can only recognise a prepayment for advertising costs until the advertising materials are made available to the entity. An entity might pay in advance for 10,000 catalogues to be printed. Many companies today would capitalise the prepayment until the catalogues are distributed. The amendment will clarify that the expense is recognised once the

catalogues have been printed and made available to the entity.

The comment deadline is 11 January 2008; the expectation is that an

amending standard will be published in April 2008, effective for annual periods commencing on or after 1 January 2009. The ED proposes that all amendments be applied retrospectively.

Meanwhile, the second Annual Improvements process is beginning, with the first proposals expected to be discussed at this month's Board meeting.

Key proposals

Proposals with significant measurement impact in certain circumstances

- IAS 39: change in the definition of a derivative
- IAS 20: imputation of interest on government loans at below-market rate of interest
- IAS 17: classification of leases of land and buildings as operating or finance leases
- IAS 17: recognition of contingent rents payable on operating leases
- IAS 19: plan amendments: recognition of curtailments and past service cost
- IAS 38: recognising prepayments for advertising and promotional activities
- IAS 39: treating loan prepayment penalties as closely related embedded derivatives
- IAS 40: classification of property under construction or

development for future use as investment property

- IAS 41: additional biological transformation
- IFRS 5: plan to sell a controlling interest in a subsidiary

Proposals likely to have modest measurement impact

- IAS 18: accounting for costs of originating a loan
- IAS 23: components of borrowing costs
- IAS 28: impairment of investment in associate
- IAS 38: unit-of-production method of amortisation
- IAS 39: reclassification of financial instruments into and out of the trading classification
- IAS 40: investment property held under lease
- IAS 39: designating hedges at the segment level
- IAS 39: applicable effective interest rate on cessation of fair value hedge accounting
- IAS 41: applicable discount rate for fair value calculations

Roundtable discussion of revenue issues

Five partners in PwC's 'Revenue, Liabilities and Other' (RLO) topic team discussed some of the key IFRS issues facing companies in this accounting area. Highlights of this roundtable discussion are reproduced below and in the next edition of *IFRS News*. This month, the discussion focuses on revenue recognition.

TD: What topics within the RLO area do you spend most time dealing with?

AD: In South Africa, the key issues are revenue recognition, taxes and share-based payment.

TF: the main topics in HK/China are fairly evenly spread between revenue, provisions, taxes and share-based payment.

DS: In the US, primarily revenue, but we also spend time on provisions, share-based payments and presentation-type issues.

TD: Revenue recognition is a difficult area, with a relatively short standard

and a lot of focus from regulators. What are some of the typical issues you see?

AD: For me, the two biggest categories are 'agency vs principal', and 'multiple-element arrangements'. There is often a default presumption that companies are acting as a principal, which increases the revenue line; it is a question of judgment sometimes to work out if they are in fact an agent or a principal.

The challenge with multiple-element arrangements is to identify multiple-element arrangements to start with, and then the identification and measurement of the various elements. A simplistic approach can sometimes see sales

transactions as comprising only a single element, whereas a more technical analysis will identify a variety of distinct components.

ML: When management identifies that the company is doing multiple things, it needs to ensure it does not take a simplistic view and considers the contract terms only. Management needs to look carefully at what the company is providing.

DS: A revenue transaction may sometimes have two components, but the first component is so integrally linked to the second that it is inappropriate to recognise revenue for that first component. For example, telephone

connection fees: is this of value to the customer without the follow-on telephone service? Would a customer purchase just the connection? Probably not, which suggests it might not be appropriate to recognise revenue for this component.

TD: Does a company get revenue just because it has incurred costs?

DS: No. There must be an identifiable service delivered to the customer. There is sometimes a belief that costs incurred before revenue can be recorded should be deferred until the revenue is recognised. But this is not necessarily the case.

TF: Both agent vs principal and multiple-element arrangements are common issues in HK/China too. So is the issue of reduction in revenue vs. expense

TD: Does this relate to allowances and accounting for discounts, rebates, etc?

TF: Yes, but it's not limited to these. Say a company gives a subsidy or incentive payment to its customers: is it a marketing expense, a reduction in revenue or a reimbursement of customers' expenses? Preparers need to focus enough on the details of the business model and goods or services being provided. Many companies have mixtures of business practices, and they should analyse the different components, which will help determine the accounting for revenue recognition and for classification.

TD: Do you see problems with where management puts the debit around customer incentives, etc?

ML: Yes. Sometimes the question of where the debit goes can be influenced by the analysis of the transaction. If you incorrectly analyse the transaction, you could put the debit in the wrong place.

IAS 18 hasn't changed, so clients sometimes ask why we are challenging their practices, but business models change. Company accountants need help from operational people to make sure the company's revenue recognition model remains applicable. If the business or the

contracts have changed, did the revenue model change with it, or should it?

TD: Companies and auditors therefore need to understand the contractual arrangements and the commercial substance of transactions.

Revenue is a complicated area and has a short standard. What has IFRIC been doing in this area recently?

DS: IFRIC 13, Customer Loyalty Programmes, gets to the heart of what companies do, particularly those companies that haven't accounted for loyalty programmes in that way in the past. The new guidance will have an impact even beyond IFRS.

ML: This interpretation also reinforces the limited guidance on multiple-element arrangements in IAS 18. IFRIC 13 deals with the concept and states the principle more clearly than IAS 18.

TD: Will it have implications for other aspects of revenue recognition?

DS: Yes, instead of having just one sentence on both separation and linkage, it's clearer what preparers should be thinking about when they ask 'Is more than one thing being sold?'.

AD: It also establishes the principle that companies can't just provide for the future costs, if they've promised customers something else in the future besides what they've initially sold.

TD: What other issues has the IFRIC addressed in the revenue area?

TF: There's an interesting ED on sale of property. It helps clarify when to apply IAS 18 and when to apply IAS 11. It explains how to recognise sales of real estate and the transfer of risks and rewards for these transactions. It also elaborates on whether an entity has multiple components when there are remaining obligations, such as minor remedial work or significant communal amenities outstanding.

TD: Will IFRIC 13, and D21 if it becomes a standard, have a

significant effect on what companies do in practice? If so, what should management be thinking about?

TF: Yes. We have seen some companies re-designing their customer loyalty packages after the publication of IFRIC 13. So there may be an impact on the business operations, not just on the accounting.

TD: Should principal and agent be considered in the context of loyalty programmes?

DS: Yes. When another entity settles the obligation on behalf of the issuer, what service has the issuer provided? If the issuer hasn't provided a service, it has no basis to recognise all of the consideration as revenue.

TD: So the income might end up being recognised as commission income on a

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net basis. The fact we've got into this discussion demonstrates it is not straight-forward. Companies need to think about accounting consequences and systems implications.

DS: We've emphasised lately that although IFRIC 13 doesn't apply until January 2009, management needs to provide comparatives for 2008, so

systems need to be in place soon to capture this information.

TD: Has the IFRIC released anything else we should be aware of in a revenue recognition context?

DS: While not authoritative, the IFRIC rejection on upfront fees provided some guidance on the recognition of revenue relating to upfront fees. It also confirmed

that incurring costs isn't enough to indicate that a service has been provided.

TD: The IFRIC also looked at the agent and principal question and concluded that no additional interpretation was needed. It decided that the standard is sufficient, and all that is needed is application guidance within IAS 18, which the IFRIC will recommend to the Board.



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