

IFRS outlook



In this issue...

What is going on with financial instruments?	2
Equity accounting: a time for change?	8
Financial reporting developments	11
Resources	18

What is going on with financial instruments?

The IASB is committed to a very aggressive timetable for publishing proposals that are intended to simplify accounting for financial instruments, whilst also converging the IFRS and US GAAP requirements. The IASB has also made several tentative decisions on classification and measurement, and impairment. Learn more about how these tentative decisions could impact your financial statements this year.

Equity accounting: a time for change?

For many years, there has been considerable debate about whether equity accounting is a one-line consolidation or a valuation methodology. The recent changes to IFRS 3 *Business Combinations* have made this debate more complex. Find out about the issues surrounding equity accounting, IFRIC discussions thus far and what may lie ahead for equity accounting.

Financial reporting developments

Find out more about the Board's discussions that could significantly impact your business: including tentative decisions on financial instruments and annual improvements. In addition, the IFRIC has made several agenda decisions that could impact your business as well.

Resources

Register for our upcoming webcast, *The lessons learned for year-end reporting*, which will be held on **Tuesday, 23 June 2009**. Register at <http://webcast.ey.com/thoughtcenter>.

We welcome your feedback on *IFRS outlook*. Please contact us at ifrs@ey.com. The next issue will be published in July 2009.

Will Rainey
Global Director of IFRS Services

What is going on with financial instruments?



The IASB is committed to a very aggressive timetable for publishing proposals that are intended to simplify accounting for financial instruments, whilst also converging the IFRS and US GAAP requirements. The IASB has also recently made several tentative decisions¹ on classification and measurement, and impairment. We explore in this article some of the tentative decisions, the impairment models being debated, the potential implications and whether they meet the two goals - simplification and convergence.

As has been widely discussed, IAS 39 *Financial Instruments: Recognition and Measurement* has nearly 20 different ways of measuring a financial instrument. This is not altogether surprising, given that financial instruments are classified into a number of categories based on type and management intent: held for trading, available for sale, held to maturity, and loans and receivables. Furthermore, changes in fair value for instruments are variously included in (a) profit or loss; (b) other comprehensive income (OCI) until the instrument is sold or impaired; or (c) not recorded at all. The measurement and impairment rules are also sufficiently complex that identical instruments are accounted for in different ways - both within and between different entities. All of this means that the diversity in application renders financial statements difficult for users to understand and compare.

IAS 39 replacement

The IASB decided at its meeting in May 2009, to deliver the replacement of IAS 39 in three stages: (i) classification and measurement; (ii) impairment of financial assets; and (iii) hedge accounting (see Table 1 on expected timing of the Board's publications on these topics). The Board's current focus is on the proposals on classification and measurement, and impairment of financial assets; the changes to hedge accounting will evolve once stages (i) and (ii) are accomplished.

Why has the IASB set such an aggressive timetable?

The IASB has received calls to 'reduce the complexity of accounting standards for financial instruments' from the G20, the Financial Stability Forum, EU Ministers and regulators from around the world. In response to this, Sir David Tweedie, IASB Chairman, said in a press release dated 24 April 2009:

"We have heard a clear and consistent message on financial instruments accounting – fix this once, fix it comprehensively, and fix it in an urgent and responsible manner. The IASB is committed to do just that by developing proposals within six months for public comment."

¹ Refer to IASB tentative decisions on IAS 39 discussed in Supplement to *IFRS outlook*, issue 42.

“Many entities will find it onerous to comply with retrospective application if they wish to early adopt the new standard for their 2009 financial statements.”

Table 1 - Summary of the Board's approach to a replacement of IAS 39

IASB publication	Key proposals ²	Expected timing
(i) Classification and measurement	<ul style="list-style-type: none"> ▶ Reduce number of classification and measurement models to two – amortised cost and fair value ▶ Instruments with basic loan features and those managed on a contractual yield basis will be at amortised cost; all other instruments will be at fair value ▶ No reclassification between the two categories after initial recognition ▶ No tainting rules for instruments at amortised cost ▶ Retain fair value option at initial recognition ▶ For certain instruments (eg., non-trading equities), allow fair value changes to be presented in other comprehensive income (OCI); no recycling allowed or impairment testing required ▶ Transition rules and implications on embedded derivatives – to be debated further by the IASB 	<ul style="list-style-type: none"> ▶ Exposure draft in July 2009 ▶ Amendments in place by October 2009 ▶ Available for 2009 financial statements (voluntary early adoption)
(ii) Impairment of financial assets	<ul style="list-style-type: none"> ▶ Current impairment rules under the incurred loss model could be replaced by another model, such as expected loss. IASB will debate this further at their June 2009 meeting 	<ul style="list-style-type: none"> ▶ Request for views by end June 2009 ▶ Exposure draft in October 2009 ▶ Amendments in place by 2010
(iii) Hedge accounting	<ul style="list-style-type: none"> ▶ To be dealt with after (i) and (ii) are accomplished 	<ul style="list-style-type: none"> ▶ Exposure draft by end of 2009 ▶ Amendments in place by 2010

Transitional provisions

The transition rules and disclosure requirements under the two-category approach are still being discussed by the Board, but they have tentatively opted for full retrospective adjustment. Detailed disclosures will be required to reflect the changes in classification in order to allow users to understand how the amendments have changed the way that entities have recorded their financial instruments.

However, due to the short time-frame, many entities will find it onerous to comply with retrospective application if they wish to early adopt the new standard for their 2009 financial statements.

In the meantime, entities must continue to apply existing IAS 39 for measuring financial instruments, including the recent IFRIC tentative guidance on the meaning of 'significant or prolonged'.³

At its June 2009 meeting, the Board will further deliberate the implications of requiring retrospective application on: the reclassifications amendment of October 2008; instruments managed on a contractual yield basis; instruments presented at fair value through OCI; hybrid financial instruments; the use of the fair value option; recalculation of effective interest rate; impairment; and hedge accounting.

² Refer to IASB tentative decisions on IAS 39 discussed in Supplement to *IFRS outlook*, issue 42.

³ Refer to Supplement to *IFRS outlook* 41. IFRIC provides tentative guidance on the meaning of 'significant or prolonged'.

What is going on with financial instruments? *continued*

Impairment of financial assets

For debt instruments which are not recorded at fair value through profit or loss (e.g., loan assets), IAS 39 currently requires impairment to be determined using an incurred loss model. The IASB has been debating a number of alternative impairment models, with the expected loss (or expected cash flow) approach being favoured by the Board as well as many constituents.

What is the issue with incurred loss?

The incurred loss model has a long history in accounting and is based on the premise that an asset is not impaired until some trigger event occurs. As a result, the incurred loss model treats loan losses as disconnected from income recognition. Everything else that is directly related to a loan is incorporated in the effective interest rate (EIR) computation - prepayment risk and income, fees, origination costs, etc. For a pool of loans, incurred losses are estimated on a collective basis, using historical experience, to reflect losses that have already been incurred, even if not yet individually identifiable. However, such an estimate does not take account of losses that are expected to be incurred in the future over the remaining life of the loans, even if they are predictable based on historical experience.

There is a common misconception that the incurred loss approach postpones loss recognition until the borrower actually defaults. In fact, default is the latest date by which impairment should be recognised. If the cause (the trigger event) and an effect (the measurement) can be identified before default, then impairment is recognised earlier. IAS 39 does not permit the recording of 'general provisions', unless these are an estimate of "incurred but not reported" loan losses where a trigger event has occurred, but the individual loan is yet to be identified, which should be reflected in the collective impairment allowance.

Other criticisms of the incurred loss model include:

- ▶ It relies on an arbitrary distinction between 'incurred credit losses' and 'future credit losses'
- ▶ A diverse range of methods are used to calculate 'incurred but not reported' (IBNR) losses in the collective impairment provisions
- ▶ It is 'pro-cyclical', in that recorded net income is higher when the economy is thriving and falls during a recession.

Expected loss model

Applying an expected loss or expected cash flow approach, as set out by the IASB staff, does not require an impairment 'trigger'. Instead, the credit losses expected at the outset are included in the estimated future cash flows used to compute the EIR, so that the impairment allowance is built up over the life of the loan. The expectations are continuously updated and any changes in the expected credit losses result in a "catch up" adjustment to profit or loss, in the same way as any other changes in expected cash flows (keeping the EIR constant).

Incurred loss -vs- expected loss

Consider a simple example (adapted from the example used in the IASB Staff Agenda Papers): a portfolio of 1,000 loans of CU 2,500 each matures in 10 years and carries an interest rate of 16%.

Table 2 on page 5 illustrates a scenario where management estimates that no loans will default in years X1 or X2. From X3 onwards, loans will default at an annual rate of about 9 per cent. If defaults occur as expected, the rate of return from the portfolio will be approximately 9.07 per cent. The example is for a fixed number of loans, without any new lending or prepayments, or any collective impairment provisions. In Table 2, the total net return (interest less loan loss) over the life of the instrument is the same under both models. However, the expected loss model has the effect of smoothing the reported income for cash flows that are not expected to accrue evenly over the life of the portfolio, while the incurred loss model results in loan loss expenses being recognised later in the life of the instrument.



Table 2

	Incurred loss					Expected loss			
	Interest income (a)	Loans, net of allowance (b)	Loan loss expense (incurred) (c)	Interest less loan loss (a)-(c)	Return, net of loan loss	Loans, net of allowance (d)	Expected loss adjustment (e)	Interest less loan loss (a)-(c)-(e)	Return, net of loan loss
31/12/X1	400,000	2,500,000	0	400,000	16.00%	2,326,689	173,311	226,689	9.07%
31/12/X2	400,000	2,500,000	0	400,000	16.00%	2,137,662	189,027	210,973	9.07%
31/12/X3	364,000	2,275,000	225,000	139,000	5.56%	1,967,496	54,834	193,834	9.07%
—	—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	—	—
31/12/X9	208,000	1,300,000	127,500	80,500	5.64%	1,260,320	(41,572)	122,072	9.07%
31/12/Y0	189,600	0	115,000	74,600	5.74%	0	(39,680)	114,280	9.07%
				1,634,600				1,634,600	

Table 3

	Incurred loss					Expected loss			
	Interest income (a)	Loans, net of allowance (b)	Loan loss expense (incurred) (c)	Interest less loan loss (a)-(c)	Return, net of loan loss	Loans, net of allowance (d)	Expected loss adjustment (e)	Interest less loan loss (a)-(c)-(e)	Return, net of loan loss
31/12/X1	400,000	2,500,000	0	400,000	16.00%	2,326,689	173,311	226,689	9.07%
31/12/X2	400,000	2,500,000	250,000	150,000	6.00%	1,900,576	176,113	(26,113)	(1.12)%
31/12/X3	324,000	2,025,000	225,000	99,000	4.40%	1,748,900	(73,335)	172,335	9.07%
—	—	—	—	—	—	—	—	—	—
—	—	—	—	—	—	—	—	—	—
31/12/X9	184,800	1,155,000	112,500	72,300	5.70%	1,119,398	(36,127)	108,427	9.07%
31/12/Y0	168,400	0	102,500	65,900	5.71%	0	(35,602)	101,502	9.07%
				1,264,100				1,264,100	

(a) Interest income computed at 16% contractual rate

(b) Contractual amount of outstanding loans, reduced by cumulative incurred losses in (c)

(c) Amount incurred as a result of events that happened during the period

(d) Present value of expected future cash flows discounted at the expected rate of 9.07%

(e) Expected loss "catch-up" adjustment, in addition to incurred loss amount

What is going on with financial instruments?

continued

Change in circumstances

It is also interesting to see how the two models reflect changing circumstances. Assume that on 31/12/X2, there is a loss event and management expects that an additional 100 loans will default in X3, and after X3 the default rate continues at 9%. The additional defaults (change in expectations) alter the expected cash flows from the entire portfolio (see Table 3). An adjustment is necessary in X2 to increase the estimate of defaults and restate the net carrying amount of the loans to the new expected cash flows, discounted at the original 9.07 per cent.

In Table 3, the expected cash flow approach reports a net loss as a result of the revised estimate in year X2, while the incurred loss approach still reports a net positive amount. That is a consequence of continuing to discount the revised cash flows at the originally computed 9.07 per cent effective rate. If the revised cash flows were discounted at the new inherent rate in the carrying amount and remaining cash flows (about 7.36 per cent), the expected cash flow approach would not report a net negative amount in year X2. While the expected loss model is generally more conservative, in X2 it results in greater volatility in the income statement due to the change in circumstances and so, in this example, is more pro-cyclical than the incurred loss model.

The above examples are simplified to show how the two models would work. Additional complexities would include:

- ▶ Transaction costs, fees, and origination costs that must be included in the EIR computation
- ▶ Prepayments, partial payments and late payments
- ▶ The effect of collective impairment provisions

Is the expected loss model better?

The expected loss model is an allocation system - while it defers the effects of some events, it also accelerates the effects of others. It is still pro-cyclical, in that reported income will reduce if credit losses are expected to get worse. The expected loss model is not necessarily less pro-cyclical than an incurred loss approach: an adjustment in reported income due to a deterioration in expectations could arise sooner and be more significant in an expected loss model, although it depends on the characteristics of the loans and incidence of losses.

Loan loss accounting will always require the application of judgment, as with other accounting estimates. To that extent, both models - incurred loss and expected loss - are dependent on management expectations, so that two entities are unlikely to arrive at the same recorded income for similar loans. Arguably, the expected loss model introduces greater judgment and more potential for diversity in application, but it has the advantage over the incurred loss model in that it eliminates any diversity of view as to whether an incurred loss has actually happened.

Expected loss - implementation challenges

The IASB and the FASB have not yet decided to move to an expected loss model, although there are strong signs that they are inclined to do so. The main challenge in transitioning from an incurred loss model to an expected loss approach will be sourcing the expected cash flow data and making the required changes in processes and systems. As many banks already determine expected credit losses for their Basel II capital requirements, they probably will not have too much difficulty in adopting the approach, although it will be necessary to see the detail of how the IASB expects it to be implemented. But the approach will certainly be more challenging for other entities.

Dynamic provisioning

There has been much discussion by regulators on the subject of 'dynamic provisioning' as a method to counter-cyclicity - not only for regulatory capital purposes, but also in the general purpose financial statements of banks. There is no common understanding or definition of what dynamic provisioning is - various approaches are used, but these tend to differ from the expected loss model in that expectations are based on losses that may arise over the entire business cycle, as opposed to over the life of the current portfolio of loans. Consequently, a higher level of impairment allowance is built up when the economy is buoyant and net income will be correspondingly higher at the bottom of the cycle.



The primary objective of financial reporting is to present unbiased and decision-useful information to the users in making economic decisions, with primacy given to the providers of debt and equity capital. Reporting a profit or loss in general purpose financial statements based on losses over the economic cycle, instead of those expected to arise on the loans actually held by an entity, is not likely to be useful to investors who need to understand the results of the period and assess the quality of earnings of the entity.

Regulators typically have the power to obtain additional information directly from an entity's management and their objectives in setting regulatory capital are not the same as those for financial reporting. If regulators are concerned that 'through the cycle losses' should be reflected in the financial statements, they are perhaps best disclosed in the notes to the financial statements or as an appropriation of reserves.

Convergence

The issue of a 'level playing field' has been brought up time and again by lobbyists in encouraging the two Boards to make competing changes over the last year. In October 2008, at the behest of governments and regulators, the IASB fast-tracked amendments that allowed the reclassification of financial instruments from one category to another in certain circumstances. In April 2009, the FASB provided additional guidance on fair values in inactive markets (FSP FAS 157-4) and relaxed its impairment rules on debt securities (FSP FAS 115-2)⁴. In response, the IASB decided not to make piecemeal changes to IAS 39 but instead, to accelerate the timing of the comprehensive project to replace IAS 39.

Although some important decisions such as which assets may be recorded at amortised cost have yet to be made, the proposals would be welcome amongst several constituents, including the EU and regulators.

The IASB's approach is yet to be adopted by the FASB, which is contemplating discounted cash flows as a third measurement category. Whilst it is clear that the IASB and the FASB are both focused on simplifying the existing requirements under their respective GAAPs, they have not yet managed to agree on fundamentals such as classification and measurement.

Concluding remarks

IFRS and US GAAP have fundamentally different starting points for financial instruments and very different impairment models so, even by itself, the convergence project is a challenge. With 'simplification' and the accelerated timing added to the equation, the two Boards have an unenviable task - to move in tandem and produce timely changes. The developments in financial instruments that unfold in the following months will be closely watched by all constituents.

⁴ Refer to Supplement to *IFRS outlook* 39 IASB conclusions on FASB proposals and plans to replace IAS 39.

Equity accounting: a time for change?



Equity accounting - is it a form of one-line consolidation or a valuation methodology? Although IAS 28 *Investments in Associates* has existed for almost 20 years, there is still no general agreement as to whether equity accounting itself is a form of one-line consolidation or merely a mechanism for measuring the investment. This ambiguity surrounding the exact purpose of equity accounting has led to differing practices emerging in a number of common situations, as noted in Box 1. In this article, we take a look at some of the issues surrounding equity accounting for an associate as a result of recent changes to standards, and consider what might lie ahead for equity accounting.

Box 1: IAS 28 refers to the use of business combination concepts and consolidation procedures when applying the equity method, but then only describes a limited number of them. This has created ambiguity as to whether consolidation and business combinations principles are to be applied fully under the equity method and raises questions as to:

- ▶ Whether the scope exemption for business combinations among entities under common control can be extended to transactions involving associates
- ▶ Whether cross holdings between associates should be eliminated
- ▶ Whether unrealised profits on transactions between associates should be eliminated
- ▶ Whether unrealised profits on transactions between the parent and the associate should be eliminated in full, or only to the extent that this reduces the carrying value of the investment to zero
- ▶ Whether loss of significant influence while retaining an interest in the investment is within the scope of IFRS 5 *Non-current Assets Held For Sale and Discontinued Operations* and, if so, how these requirements are applied.



In the last 18 months the confusion around this debate has increased. Standards relating to business combinations and consolidated financial statements have been revised, with minor consequential changes to the standard for applying equity accounting – namely, to remove the direct cross-reference to the business combinations standard, but retaining a reference to the concepts of business acquisition accounting. While one view may simply be that the IASB did not fully consider the impact of the revisions on the equity method of accounting, it is more likely that this may be the first in a number of steps by the IASB to take a more fundamental look at the role of equity accounting.

Although the IASB has not added a separate project to its agenda to revisit accounting for associates in full, it is evident that discussions are ongoing concerning the future of equity accounting.

The fundamentals – determining cost

The starting point for applying equity accounting is the cost of the investment. IAS 28 does not define cost: until the recent changes were made to IAS 28, it referred to IFRS 3 *Business Combinations*, which specifically defined the cost of the investment used for calculating goodwill. However, with the move to a fair value method of accounting for business combinations, the definition of cost was removed from IFRS 3. As cost is no longer defined in this standard, the question now arises as to how relevant the requirements of the business combinations standard are in determining cost, and, in particular:

- a. Should transaction costs be included?
- b. How should contingent consideration be accounted for?
- c. How should step acquisitions of associates be accounted for?

Transaction costs

Under the new approach to business combinations, transaction costs are expensed as they do not represent part of the fair value of the consideration given. Does this new business combination principle now apply for equity accounting? This matter was referred to the IFRIC, which tentatively decided at its May meeting, that the cost of an investment in an associate comprises ‘its purchase price and any directly attributable expenditure necessary to obtain it’. Assuming the IFRIC confirms this decision, it appears that transactions costs incurred to acquire an associate will continue to be included in its cost. However, this tentative decision is a move away from applying business combination principles.

Contingent consideration

The revised business combinations standard also changes the accounting for contingent consideration – requiring an initial evaluation of its fair value to be determined as part of the consideration given, with all subsequent changes generally being recognised in the income statement. In contrast, under the former standard, changes in estimates of contingent consideration were adjusted against the combination, i.e., goodwill. However, the IFRIC statement that cost comprises the purchase price does not help to clarify which approach is now required for equity accounting.

Step acquisitions of an associate

The revised business combinations standard also significantly changes the accounting for a step acquisition of a subsidiary. Now, any existing ownership interest will be re-measured to fair value through profit or loss at the date control is acquired. IAS 28 is silent on this matter. However, its reference to using the concepts of acquisition accounting appear to suggest that this new approach for step acquisitions is also appropriate for associates. It would be logical to conclude that the IFRIC reference to purchase price would help solve this issue. However, when this statement is considered along with other changes to the standard on consolidated financial statements, uncertainty remains.

Equity accounting: a time for change? *continued*

In particular, the standard on consolidation notes that, on loss of control, any remaining interest (including that giving rise to an investment in an associate) is to be fair valued at the date control is lost. The reason for these changes is that the change from a subsidiary to an associate, and vice versa, is a significant change in the nature of and economic circumstances surrounding the investment. Therefore, the principle applied is that the existing investment is given up as consideration for acquiring a different type of investment. It would appear logical that the accounting treatment applied when gaining significant influence from an increase in shareholding would mirror that applied when it is obtained by decreasing the shareholding. The effect of these different approaches is reflected in Box 2.

Box 2: Example of step acquisition of an associate applying the different philosophies of cost.

Scenario 1

In year 1, entity A acquires 10% of entity B for CU200 and classifies it as available for sale. In year 2, entity A acquires an additional 20% for CU800 and obtains significant influence. At that date, the original 10% has a fair value of CU400. What is cost?

Traditional cost approach - simple addition of the cash outflows to result in a cost of CU1,000.

Consolidation concepts - addition of the cash outflow for the final stake and the fair value of the existing interest to result in a cost of CU1,200. A gain of CU200 is recognised in the income statement.

Scenario 2

Entity A had a 100% ownership in entity B for which it paid CU4,000 and consolidates the subsidiary. In year 10, entity A disposes 70% of its interest and obtains significant influence. The fair value of the 30% retained is CU1,200.

The consolidation standard requires that the cost is the fair value - CU1,200.

What lies ahead for equity accounting?

The new concepts underlying business combinations represent a clear change of direction by the IASB away from a cost approach to a fair value approach. This move creates a conceptual difference between accounting for subsidiaries and associates, thereby providing some evidence that it is not a one-line consolidation. Yet many links between the accounting for a subsidiary and an associate still remain, consequently, retaining much of the confusion to understanding the purpose of equity accounting. The IASB, as part of its 2009 Annual Improvements project, further hinted that equity accounting is not a one-line consolidation - yet the links still remain. Such comments and actions suggest that, after 20 years of entities applying equity accounting, the IASB may be leaning towards the view that equity accounting is more akin to a method of valuation. With increased pressure to reduce the number of measurement bases, does this mean that fair value accounting for the investment is the next logical step in further refining this method of valuation to replace the concept of equity accounting altogether?

Financial reporting developments

The IASB (the Board) met in London on 18 - 21 May 2009 and the IFRIC met on 7 May 2009. The table below summarises the main issues discussed. In the following pages, you will find more detailed information and insights about the shaded items in the table.

Projects	Key discussion points	Status
Financial instruments - recognition and measurement	The Board made several tentative decisions on its IAS 39 replacement project. Refer to <i>Supplement to IFRS outlook, Issue 42: IASB tentative decisions on IAS 39</i> and page 2 of this publication.	ED expected July 2009
Measurement of liabilities - credit risk	The Board agreed to issue a Staff Paper discussing the role of credit risk in the current measurement of liabilities.	
Financial instruments with characteristics of equity	The Board discussed a set of principles to determine whether a financial instrument should be classified as equity and a set of decision rules to make the principles operational.	ED expected Q4 2009
First-time adoption of IFRS	<p>Discussed responses to the Exposure Draft <i>Additional Exemptions for First-time Adopters: Proposed Amendments to IFRS 1</i>.</p> <p>The Board tentatively decided that the proposed scope exemption for rate regulated activities should be within the scope of the proposed ED on rate regulated activities. Further discussion is deferred until the project has progressed.</p> <p>The exemption from determining whether an arrangement contains a lease would apply whether the previous GAAP (which produces the same result as IFRS) was applied prospectively or retrospectively. Consequently, the entity should assess all leases once - either in accordance with previous GAAP or at the date of transition to IFRS.</p>	IFRS expected Q3 2009
Insurance contracts	<p>Tentatively decided two aspects of how an insurer should measure its insurance contracts:</p> <ul style="list-style-type: none"> ▶ Include the expected (i.e., probability-weighted) cash flows resulting from those contracts (including the exercise of options). ▶ To distinguish between existing and new contracts, the starting point being whether the insurer can cancel the contract or change its pricing or other terms. 	ED expected Q4 2009
Joint ventures	<p>Tentatively decided:</p> <ul style="list-style-type: none"> ▶ To replace 'shared decision-making' with 'joint control' ▶ To have only two types of joint arrangement, namely joint operations (by merging 'joint operation' and 'joint assets') and joint ventures ▶ If the joint arrangement is a separate entity, all relevant facts and circumstances would need to be considered in order to determine whether it is a joint operation or joint venture. 	IFRS expected Q3 2009

ED = Exposure Draft, DP = Discussion Paper, Q2 2009 = Second quarter of 2009, H1 = First half of 2009, H2 2009 = Second half of 2009.

Financial reporting developments *continued*

Projects	Key discussion points	Status
Leases	<p>Discussed the application of the right-of-use model to a lessor and tentatively decided that, under this approach, the lessor retains the leased item in its statement of financial position and recognises:</p> <ul style="list-style-type: none"> ▶ An asset for its right to receive rental payments from the lessee; and ▶ A liability for its performance obligations under the lease. 	ED expected H1 2010
Post-employment benefits	<p>In respect of disclosure requirements, tentatively decided to:</p> <ul style="list-style-type: none"> ▶ Align the requirements with those in IFRS 4 <i>Insurance Contracts</i> and IFRS 7 <i>Financial Instruments: Disclosures</i> ▶ Expand the requirements for multi-employer plans ▶ Include the effect of plan amendments and a narrative description of such amendments ▶ Include non-routine settlements (events not covered by actuarial assumptions). 	ED expected Q3 2009
Rate-regulated activities	<p>Tentatively decided that a regulatory asset is to be recognised for all identifiable costs of self-constructed assets the regulator permits in the determination of rates that are not otherwise elements of cost under other standards.</p> <p>The discount rate used to measure regulatory assets and liabilities would be determined on a basis consistent with IAS 36 <i>Impairment of Assets</i> and IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>.</p>	ED expected Q3 2009
Revenue recognition	<p>Tentatively decided that:</p> <ul style="list-style-type: none"> ▶ Renewal options are to be accounted for as performance obligations if their stand-alone selling price can be determined without undue cost ▶ A customer's credit risk is reflected in the initial measurement of the net contract position and, therefore, ultimately in the amount of profit recognised when a performance obligation is satisfied ▶ When consideration cannot be reliably estimated, no revenue is recognised from the transaction. 	ED expected Q3 2009
Annual improvements 2009	<p>Made tentative decisions about:</p> <ul style="list-style-type: none"> ▶ Interim financial reporting ▶ Business combinations. 	ED expected Q3 2009



Projects	Key discussion points	Status
IFRIC agenda decisions	<p>The IFRIC tentatively decided not to add the following issues to its agenda:</p> <ul style="list-style-type: none"> ▶ Acquisition-related costs in a business combination ▶ Early application of IFRS 3 ▶ Determination of cash equivalents ▶ Transaction costs for non-controlling interest in the consolidated financial statements ▶ Equity method accounting ▶ Venture capital consolidations and partial use of fair value through profit or loss ▶ Impairment of investments in associates ▶ Interim disclosures about fair value ▶ Compliance costs for REACH ▶ Hedging using more than one derivative as the hedging instrument ▶ Meaning of 'significant or prolonged' ▶ Scope of IFRIC 12 <i>Service Concession Arrangements</i> ▶ Application of IFRIC 18 <i>Transfers of Assets from Customers</i>. 	IFRIC to confirm its tentative decision at its next meeting in July

ED = Exposure Draft, DP = Discussion Paper, Q2 2009 = Second quarter of 2009, H1 = First half of 2009, H2 2009 = Second half of 2009.

Financial reporting developments *continued*

IFRIC - items not taken onto the IFRIC's agenda

IAS 12 Income taxes - Classification of tonnage taxes

IFRIC was requested to provide guidance on whether a tax-based on tonnage capacity could be considered an income tax in accordance with IAS 12. The IFRIC believes that IAS 12 applies to taxes levied on taxable profit, implying a notion of net rather than a gross amount. Consequently, IAS 12 would not be applicable. However, the IFRIC noted that an entity should present additional analysis (subtotals) of the tonnage taxes in the financial statements that would be relevant to users, in accordance with IAS 1 *Presentation of Financial Statements*.

IAS 16 Property, Plant and Equipment - Disclosure of idle assets and construction in progress

The IFRIC received a request for more guidance on the extent of required disclosures relating to property, plant and equipment temporarily idle, or for assets under construction when additional construction has been postponed.

The IFRIC noted the specific requirements of IAS 16 paragraph 74(b) and the general requirements of IAS 1 paragraph 112(c), where an entity is to provide information relevant to users not already presented elsewhere in the financial statements.

The IFRIC recommended that the Board should undertake a review of all disclosures encouraged (but not required) by IFRSs, with the objective of either confirming that they are required or eliminating them.

IAS 38 Intangible Assets - Accounting for sales costs

The IFRIC was asked to clarify how a real estate developer should account for selling and marketing costs incurred during construction that relate to the specific real estate construction project. The IFRIC believes the specific facts and circumstances impact whether such costs can be capitalised, and it would not be possible to reach a conclusion on the appropriate accounting for broad categories of selling and marketing costs in all circumstances.

IAS 39 Financial Instruments: Recognition and Measurement - Participation rights and the calculation of the effective interest rate

The IFRIC was asked for guidance on how an issuer should account for a fixed rate financial liability (measured at amortised cost) that gives the holder the right to share in the profits and losses of the issuer. It was assumed that the instrument does not contain any embedded derivatives. The IFRIC noted that the existing guidance in AG6 and AG8 of IAS 39 is applicable. This requires that any changes in estimates of the amounts payable would be recognised as a "catch up" adjustment in profit or loss, with the effective interest rate remaining the same.

IAS 39 Financial Instruments: Recognition and Measurement - Classification of failed loan syndications

This issue arises when an entity originates a loan with the intention of syndication, but cannot find sufficient participants. The entity then tries to sell the surplus loan amount to other parties in the near term. The IFRIC was asked whether the retained portion of the loan must always be classified as "held for trading".

The IFRIC noted that the classification is dependent on whether the instrument meets the definition as "loans and receivables" or "financial asset at fair value through profit or loss", that is, whether the entity intends to sell the loan in the near term, not whether it was acquired with trading intent.

IAS 41 Agriculture - Discount rate assumption used in fair value calculations

The IFRIC was asked for guidance on how an entity should determine an appropriate discount rate when the fair value of biological assets is estimated using the present value of expected net cash flows. The IFRIC believes that guidance that is already available in IFRSs, including IAS 39 and other materials recently published, can be applied to biological assets.



Financial instruments with characteristics of equity

The Board supported a set of draft principles to identify equity instruments which will be refined at future meetings. The principles incorporate the tentative decisions previously made:

- ▶ An equity instrument is always subordinated to a liability instrument, but may be senior to other classes of equity.
- ▶ An instrument is equity if it has no settlement requirement other than when the issuer winds up its operations and distributes all of its assets.
- ▶ If an instrument is settled only when the holder ceases to take an interest in the activities of the entity (e.g., on retirement or death) and the holder was required to hold the instrument in order to engage in the activities of the entity, then the instrument is equity. For example, many partnership interests are automatically redeemed when a partner dies or retires. All other instruments with settlement requirements are liabilities or hybrid instruments (part equity or part liability).
- ▶ An instrument is separated into liability and equity components if the instrument has two separate or alternative outcomes either as equity or liability, if that was the only outcome. For example, a puttable instrument redeemable at the option of the holder has two possible outcomes, i.e., it could be redeemed (a liability) or could remain outstanding (equity). As there is both an equity and a liability outcome, the instrument is separated into two components.
- ▶ A claim to a percentage of the assets that remain after all senior claims have been satisfied is neither necessary nor sufficient to identify an equity instrument.

The Board discussed some decision rules to implement the principles, for example, retained earnings and capital contributions must be classified as equity and an instrument that has a fixed settlement.

Annual improvements

Business combinations

The Board agreed to propose the following amendments as they relate to the revised standard on business combinations and consolidated financial statements:

- ▶ Consequential amendments made to IAS 27, IAS 21, IAS 28 and IAS 31 are to be applied prospectively rather than applying IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (see the March 2009 edition of *IFRS outlook* for a discussion of these amendments).
- ▶ Contingent consideration on acquisitions arising prior to application of the revised IFRS 3 is not accounted for under the revised IFRS 7, IAS 32 and IAS 39.
- ▶ When it is highly probable that an entity will derecognise an investment in an associate or a jointly controlled entity and gain control, no separate classification of the investment as an asset held for sale is to be made. Conversely, separate classification as held for sale should be made when it is highly probable that the entity will lose joint control or significant influence in the associate or jointly controlled entity, and retain a lower investment.

On the basis that current requirements were already clear, the Board also tentatively decided not to amend the revised IFRS 3 or IAS 27 for the following:

- ▶ Total comprehensive income is to be attributed to the parent and non-controlling interests based on ownership interests. IAS 27 notes that this amendment is applied prospectively, meaning that there is no reallocation of past losses on transition or subsequently.
- ▶ The parent is required to redistribute other comprehensive income between the owners of the parent and NCI when a change in ownership interest (without a loss of control) occurs.
- ▶ Notwithstanding IFRS 3 which permits early application only for periods on or after 30 June 2007, first time adopters apply IFRS 1, where this limitation is not applicable.

Financial reporting developments *continued*

IFRIC tentative agenda decisions

IFRS 3 Business Combinations - Acquisition-related costs in a business combination

The IFRIC received requests to clarify the treatment of acquisition-related costs that the acquirer incurred before it applies the revised IFRS 3 that relate to a business combination that is accounted for according to the revised standard.

As this was a one-time transitional issue and there could be more than one interpretation of how such costs could be treated, the IFRIC believes that an entity should disclose the amount recognised in the financial statements and the accounting policy applied for such costs.

IFRS 3 Business Combinations - Early application of IFRS 3

The IFRIC was asked to clarify whether the revised IFRS 3 had to be applied from the beginning of an annual period if it was adopted early.

The IFRIC believes that relevant guidance on the early application of IFRS 3 already exists in IFRSs and should be answered in accordance with the general principles in IAS 8.

IAS 7 Statement of Cash Flows - Determination of cash equivalents

A request was received by IFRIC for guidance on whether investments in shares or units of money market funds or other funds that are redeemable at any time can be classified as cash equivalents.

The IFRIC noted that paragraph 6 of IAS 7 defines cash and cash equivalents as 'convertible to known amounts of cash' and 'subject to an insignificant risk of changes in value'. Hence, the amount of cash that will be received must be known at the time of the initial investment and not just readily convertible to cash at the then market price in a liquid market. The IFRIC also noted that the entity would need to satisfy itself that any investment was subject to an insignificant risk of changes in value for it to be classified as a cash equivalent.

IAS 27 Consolidated and Separate Financial Statements - Transaction costs for non-controlling interests

The IFRIC was asked to clarify how transaction costs incurred on the acquisition or disposal of non-controlling interest (NCI), that does not result in the loss of control of an entity, should be treated. The IFRIC noted that transactions with NCI would be treated as equity transactions under IAS 27 and IAS 1 *Presentation of Financial Statements*. Therefore, transaction costs arising would not be part of income and expenses for the period.

IAS 28 Investments in Associates - Potential effect of IFRS 3 Business Combinations (as revised in 2008) and IAS 27 on equity method accounting

The IFRIC deliberated two issues relating to equity accounting, and concluded that:

- ▶ The initial carrying value of an equity method investment is its cost, which comprises its purchase price plus any directly attributable expenditure necessary to obtain it.
- ▶ An equity method investee's issue of shares leading to a reduction in the investor's ownership interest without loss of significant influence is accounted for as any other reduction in interest. In such cases, a proportion of any gains or losses included in other comprehensive income are reclassified to the income statement.

IAS 28 Investments in Associates - Impairment of investments in associates

The IFRIC received a submission to consider whether guidance was needed on how impairments of investments in associates should be determined in the separate financial statements of the investor.

The IFRIC noted that as it was not clear whether the cost of investment recognised in the separate financial statements of the investor should be determined in accordance with IAS 36 or IAS 39 *Financial Instruments: Recognition and Measurement*, the issue would be referred to the IASB.

IAS 28 Investments in Associates - Venture capital consolidations and partial use of fair value through profit or loss

The IFRIC was requested to provide guidance on accounting for an associate where part of the investment is held by a subsidiary that applies the equity method, and part is held by another subsidiary that qualifies for the venture capital (VC) exemption in IAS 28 and is therefore carried at fair value. The issue is whether on consolidation, both measurement bases can continue to be used, or whether it must be accounted for as 'one' investment.

The IFRIC noted that significant diversity exists in practice because of conflicting guidance within IAS 28 and between IAS 28 and other standards and that the issue would best be resolved by the IASB.



IAS 34 Interim Financial Reporting - Interim disclosures about fair value

In response to a request for guidance on whether updates to annual fair value disclosures are required in condensed interim financial reports, the IFRIC noted IAS 34 provided sufficient guidance, that when an event or transaction is significant to the understanding of the changes in an entity's financial position or performance since the last annual financial period, the interim report should provide an explanation or update to previously reported annual financial information.

IAS 38 Intangible Assets - Compliance costs for REACH

The IFRIC received a request to provide guidance on the treatment of costs incurred to comply with the requirements of the European Regulation concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH). The IFRIC believes that IAS 38 already includes definitions and recognition criteria for intangible assets relevant to entities accounting for costs of complying with the REACH regulation.

IAS 39 Financial Instruments: Recognition and Measurement - Hedging using more than one derivative as the hedging instrument

The IFRIC was asked for guidance on how more than one derivative may be used in a hedge accounting relationship. The submission considered an example where an entity issues fixed rate foreign currency debt and enters into both a cross currency interest rate swap to convert the instrument into a floating local currency borrowing, and also a local currency interest rate swap to fix the interest rate payments for part of the debt life. The IFRIC noted that paragraph 77 of IAS 39 permits two derivatives to be jointly designated as the hedging instrument. However, in this example, the first derivative would need to be designated as part of a synthetic instrument hedged by the second derivative and it is not permitted to designate a derivative as a hedged item. It also noted that any guidance it could provide would be in the form of implementation guidance.

IAS 39 Financial Instruments: Recognition and Measurement - Meaning of "significant or prolonged"

IAS 39 states that, for equity instruments that are available for sale, objective evidence of impairment includes a significant or prolonged decline in fair value below cost. "Significant or prolonged" is not defined and IFRIC has provided guidance. Refer to *Supplement to IFRS outlook, Issue 41: IFRIC provides tentative guidance on the meaning of "significant or prolonged"*.

IFRIC 12 Service Concession Arrangements - Scope of IFRIC 12

The IFRIC deliberated two issues relating to the application of IFRIC 12 and concluded:

- ▶ Any reviews or approvals by the grantor required by the agreement would suffice to indicate that the grantor controls or regulates the price of the service. The IFRIC noted that it would be inappropriate to assume that approvals or reviews are perfunctory or 'rubber stamps' that could be disregarded.
- ▶ Accounting for aspects of the arrangement other than the infrastructure, are not within the scope of IFRIC 12. IFRIC 12 refers to other IFRSs for guidance for accounting for such aspects.

IFRIC 18 Transfers of Assets from Customers - Applicability to the customer

A request was received to provide guidance on how the customer should account for a transfer of assets that is within the scope of IFRIC 18 for the recipient. The IFRIC noted a transfer includes an exchange of goods or services, or both, and that relevant guidance for accounting for the goods or services received or given up in an exchange transaction are included in other IFRS.

New documents issued

Project	Effective date
ED of <i>Fair Value Measurement</i>	Open for comment until 28 September 2009
ED of <i>Prepayment of a Minimum Funding Requirement</i> – Proposed amendment to IFRIC 14	Open for comment until 27 July 2009

Resources

Supplements to *IFRS outlook*, Issues 41 – 44

Issue 41: IFRIC provides tentative guidance on the meaning of 'significant or prolonged'

The lack of application guidance in IAS 39 *Financial Instruments: Recognition and Measurements* on the meaning of a 'significant or prolonged' decline in the fair value of an equity instrument (that is classified as available-for-sale) to establish whether it is impaired, has led to considerable diversity in practice. In response to requests for guidance, the IFRIC has issued a Tentative Agenda Decision to provide clarifications on the practices that are inconsistent with IAS 39. Read our summary of the IFRIC's guidance and the potential implications for your business. Comments are due by 22 June 2009.

Issue 42: IASB's tentative decisions on IAS 39

The IASB has adopted a working premise to use a two-category approach to measure financial instruments at either fair value or amortised cost. Under this approach, the Board expects to: retain a fair value option; prohibit reclassifications between the two categories; eliminate 'tainting' rules; and for certain instruments, allow presentation of fair value changes in other comprehensive income. A new ED containing these proposals is expected in July 2009, with the final standard expected in time for 2009 year-end financial statements. For financial instruments at amortised cost, the IASB will debate further on possible impairment approaches for financial instruments, including expected loss and fair-value based models.

Issue 43: ED - Fair value measurement - proposals for a new standard

In response to issues that arise when assets, liabilities and equity instruments are measured at fair value, the IASB issued an ED proposing a single definition of fair value; the establishment of a single framework for measuring fair value; and the extension of the disclosures required when fair value information is disclosed or used as a measurement method. The proposals are likely to result in companies having to make changes to their information systems to accommodate the extended disclosure requirements and to re-evaluate their processes and procedures for determining fair value. This supplement summarises the key proposals in the ED and the key business impacts and challenges that entities may initially face. Comments are due by 28 September 2009.

Issue 44: Prepayments of a minimum funding requirement - proposed amendment to IFRIC 14

The application of the guidance in IFRIC 14 for applying IAS 19 Employee Benefits, to restrict a pension asset in a defined benefit plan to its recoverable amount, has had a number of unintended consequences for entities in some jurisdictions. The IASB has proposed a limited amendment to give entities the ability to recognise an asset for prepayments of minimum funding requirement contributions. This supplement contains an example illustrating how this amendment would apply and considers the impact for businesses.

Metals & Mining refining IFRS

Restricted access for capital leads to increased farm-outs

Our Refining IFRS series aims to examine the complex, but unique, issues faced by mining and metals companies applying IFRS. These issues will be considered in the context of recent and current developments in the global mining and metals market place.

Insurance accounting alert: IASB staff updates measurement candidates and timetable for new insurance standard and recommends field testing

In anticipation of the IASB's forthcoming meeting on 18 June 2009 on candidate measurement approaches for insurance contracts, this publication summarises the topics discussed and the tentative decisions made to date. It also outlines the recommendations the Staff will make to the IASB and the FASB on these approaches when they meet in July 2009 to select a measurement approach, including the approach based on the updated IAS 37 model and a proposal for field testing.



Archived webcasts

Proposed changes to accounting for income taxes under IFRS

Anne McGeachin, the IASB's Senior Project Manager on the income taxes project joined a panel of Ernst & Young professionals to discuss several aspects of the IASB's much-anticipated ED to replace IAS 12 *Income Taxes*. The ED proposes several changes to the current requirements of IAS 12, including new requirements for the accounting and disclosure of uncertain tax positions, and definitions of 'tax base' and 'temporary difference'. Income taxes are a significant item for all reporting companies and any changes to how they are accounted for can have a fundamental impact on a company's balance sheet and income statement, as well as on disclosures. To listen to the webcast, go to <http://webcast.ey.com/thoughtcenter>.

IFRS 1 – Focus on new converting countries

Converting to IFRS has the potential to impact business operations throughout a company because it is much more than an accounting exercise. A company with a well-executed transition plan starts with a clear understanding of the transition rules that can enhance the effectiveness of its conversion by evaluating the potential implications well in advance. Danita Ostling, Americas IFRS Technical Leader, together with Sven Hayn, Tai Danmola and Andrew Walton from Ernst & Young, discussed the impact of IFRS 1, in particular, the policy choices allowed and the potential range of change-management processes. The webcast is aimed at those seeking to gain an edge in the conversion process by understanding the potential impacts of voluntary exemptions before those accounting options take place. To listen to this webcast, go to <http://webcast.ey.com/thoughtcenter>.

Coming soon

IFRS webcast series

The lessons learned for year-end reporting

Tuesday 23 June 2009 [9:00-10:00 London, 10:00-11:00 Paris, 17:00-18:00 Hong Kong, 18:00 - 19:00 Sydney]

The December 2008 reporting cycle has been one of the most challenging in several years - as a result of the deterioration in the economy and the level of uncertainty about the future. As we move into the June reporting cycle - both interim and year end in some countries - and as the rate of changes in the economy is slowing down, we can reflect on what lessons have been learnt.

In our November 2008 webcast entitled, *Preparing for the year-end in the current environment*, we highlighted the critical areas in financial reporting that were likely to arise during the 2008 year-end reporting season. In this webcast, we will discuss with a panel of specialists, their observations on the challenges companies faced in the 2008 year end reporting season, including the trends reflected in annual reports that have been released. We will look, in particular, at key areas such as impairment, financial instruments, restructuring and disclosure requirements. We will also look at some of the new challenges that companies are likely to face implementing some new standards in this environment.

This webcast is aimed at CFOs and controllers keen to take a proactive approach to addressing the potential issues and pitfalls in the upcoming reporting season. Join Lynda Tomkins, a member of Ernst & Young's Global IFRS Services team, as she discusses with a panel of experienced professionals the impact and lessons learnt by companies when preparing their 2008 financial reports, go to <http://webcast.ey.com/thoughtcenter>

Ernst & Young

Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 135,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

For more information, please visit www.ey.com

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients.

About Ernst & Young's International Financial Reporting Standards Group

The move to International Financial Reporting Standards (IFRS) is the single most important initiative in the financial reporting world, the impact of which stretches far beyond accounting to affect every key decision you make, not just how you report it. We have developed the global resources – people and knowledge – to support our client teams. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how Ernst & Young makes a difference.

www.ey.com/ifrs

© 2009 EYGM Limited.
All Rights Reserved.

EYG no. AU0312

In line with Ernst & Young's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.