IFRS news

Emerging issues and practical guidance*

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Reporting entity takes shape at the IASB

Partner in the Global Accounting Consulting Services central team and *IFRS news* publisher Mary Dolson looks at how some of the forthcoming standards might align the reporting entity with the business model.

The successful completion of three currents projects (and a possible fourth) would constitute a reshaping of the reporting entity. The projects are:

- ED 9, 'Joint activities': a standard expected mid 2009.
- ED 10, 'Consolidated financial statements': standard scheduled for early 2010.
- Derecognition: ED expected in April 2009; standard scheduled for 2010.
- The possibility of a project on equity accounting.

Will the changes resulting from these projects align the reporting entity more closely with the business model seen through management's eyes?

Some of the changes are predictable, but others are less clear. The finalisation of ED 9 will see the end of proportionate consolidation as a policy choice. Proportionate consolidation is often used with a business model based on cooperation with local partners or for projects that are both risky and expensive with no single entity able to absorb the risk or supply the capital. Adoption of the dual model (own assets, liabilities and equity for the residual) or equity accounting will be mandated.

The current projects on consolidation and derecognition at the IASB pre-dated the current economic crisis but were accelerated as a consequence of it. Planned discussion papers were scrapped for both. These projects grapple with a fundamental question in accounting: what's in the reporting entity and what's not?

ED 10 proposes a single, control-based model. Observers seem split: some reject the proposals, calling for more disclosure immediately and further consideration of other changes; others see the potential to improve practice and eliminate some diversity. ED 10 sought comments on equity accounting, with the tantalising possibility that IAS 28, 'Investments in associates', poised awkwardly between a collapsed consolidation and a financial asset, could be up for improvement.

The derecognition project is expected to result in an exposure draft with, unusually, two models. The exposure draft is expected to have a 120-day comment period, and the IASB is planning roundtables.

These projects are an opportunity to reshape the reporting entity. The accelerated timetable presents a real challenge, with major projects moving straight to exposure drafts. A good result is crucial for high-quality financial reporting.

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Proposals for revenue recognition – an overview

The IASB issued the long-awaited revenue recognition discussion paper in December 2008. Mark Lohmann and Katie Woods in PwC's Global Accounting Consulting Services provide some background to this paper and outline the key issues. This month's *IFRS news* supplement, 'The future of revenue recognition' contains more detail of the proposed requirements.

This joint IASB/FASB project sits near the top of the convergence road-map of 'projects to be finalised by 2011'. A converged revenue standard would go some way to eliminate the 200 different pieces of US accounting guidance on revenue recognition as well as existing IFRS guidance in IAS 18, 'Revenue' and IAS 11, 'Construction contracts'. There is a perception that US guidance is voluminous and the IFRS guidance seems to lack guidance or be in consistent. For example, IFRS lacks guidance in identifying and measuring components in multiple-element arrangements.

What are the main proposals?

Revenue recognition will be based on the changes in contract assets and liabilities using a single contract-based revenue recognition model. All revenue contracts (with the possible exception of contracts for financial instruments, insurance and leasing) will apply the same revenue recognition model. The contract is comprised of contract assets (the right to receive payment) and contract liabilities (the obligation to perform under the contract). Revenue is recognised when either the net contract liability is reduced or the net contract asset has increased, both as a result of the entity discharging its contract liabilities by performing.

This may make sense conceptually; however, the practical reality is more complicated. The first area to consider is what the proposals mean by 'performing'. Each contract will need to be broken into performance obligations (the promise to transfer an asset – either a good or service). Revenue is recognised as control of the promised asset for each of the obligations is passed from the seller to the buyer. Performance obligations are similar to the concept of separable deliverables and components of an arrangement but may be wider than those seen in current practice. Then there is the concept of control: how does it compare with current requirements?

An example of the impact of using change in control to recognise revenue is seen when looking at construction contracts and, where applicable, service contracts. These have historically been accounted for under the percentage-of-completion method. This method will no longer exist. Revenue in such arrangements will be recognised based on transfer of control. If control passes during the period of construction or service (referred to as continuous transfer), revenue recognition is likely to be similar. If it does not, revenue will be deferred until the customer takes control of the asset. For example, a ship yard building a ship often applies percentage-of-completion accounting and recognises revenue as the ship is built. Under the proposed model, the control of the ship transfers when it is finished. The building of the ship represents inventory, and revenue is recognised when the ship is complete and control is transferred to the customer.

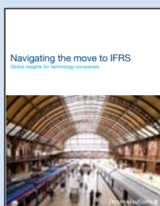
Risk and reward transfer will no longer be relevant in assessing whether revenue should be recognised. Other criteria used today such as acceptance of the good, customer intent or payment terms will only assist in identifying when control has been transferred. The singular focus on transfer of control could result in a legalistic approach to revenue recognition.

Another significant area of change is in relation to costs. The proposed standard does not intend to give any guidance on cost recognition. Management will be required to look to other standards (IAS 2, IAS 16 and IAS 38) to determine how costs are accounted for.

Some areas are not covered by the discussion paper, such as measurement of the contract asset (including impact of time value of money and contingent consideration), contract modifications, presentation and disclosure and application guidance on the identification, satisfaction and measurement of performance obligations. The Board will continue to discuss these during the DP's comment period.

The deadline for comments is 19 June. Preparers and users should consider the impact that these proposals will have, as changes in the accounting for revenue could impact nearly all entities.

IFRS transition guidance for technology sector



PricewaterhouseCoopers technology group has released guidance on transition to IFRS for the industry in the US.

Navigating the Move to IFRS: Global Insights for Technology Companies explores the key accounting topics that are most relevant to technology companies and potentially complex areas of difference between US GAAP and IFRS. These include revenue recognition, research and development, share-based payments and income taxes.

Contact your local PwC office to order hard copies. The PDF can be downloaded from www.pwc.com/technology

Beginners' guide: debt or equity?

You may stay awake at night worrying about the economy or whether your children will get into university. But maybe there's something else that should be occupying your mind – is it debt or is it equity? Marie Kling and Tina Farington of PricewaterhouseCoopers' Accounting Consulting Services in the US give you something else to worry about in this beginner's guide to debt and equity.

Common shares that give a residual interest in an entity are equity and a standard-term loan offered by a bank is debt (financial liability). Between these two simple points lies a host of instruments for which the question "Is it a financial liability or is it equity?" can be more challenging to answer, particularly as many entities look to shore up their balance sheets as a result of recent market events. Many performance indicators and lending covenants are measured by these accounting concepts. The distinction is also important because changes in the value of equity are not recorded in the financial statements, but subsequent changes in the value of a financial liability will affect the income statement. Re-measurement of a financial liability in these turbulent times can create significant income statement volatility.

Given the potential consequences, management should not underestimate what may seem like a simple question, as the guidance can sometimes be challenging to navigate.

Defining financial liability and equity

Assets minus liabilities equals equity, meaning equity is generally understood as a residual concept. This concept is also embedded in the financial instruments guidance. IAS 32, 'Financial instruments: Presentation', provides a definition of a financial liability, and equity is considered to be the residual. How do these concepts work in practice?

Financial liability – a contractual obligation to pay cash

A financial liability is a contractual obligation to deliver cash or another financial asset, which an entity cannot avoid. This obligation can be created in a number of ways.

The obligation may be a simple one to pay cash on specified dates in the future in exchange for cash received today. For example, an entity issues a bond for C100 that pays interest of 10% annually until it matures in 10 years. At the end of the 10 years, the principal will be repaid. The instrument is a financial liability from management's perspective. The entity is contractually obliged to pay cash for the interest and principal.

The obligation to pay cash may occur at unspecified dates in the future. For example, an instrument may have features that allow for early repayment. A bond may be issued with a 'call' feature that allows the entity to call the debt and pay the holder. For example, the instrument may also contain a 'put' that allows the holder to ask for repayment. This instrument is also a financial liability* despite the uncertainty about when the principal will be repaid.

Finally, the obligation to pay cash may occur as a result of an event that is outside the control of entity and the investor. For example, an entity issues an instrument that is repayable in cash if the entity does not achieve a successful listing on the local stock exchange by a specified date. The entity is obliged to pay cash if the successful listing does not occur. This instrument is also a financial liability.

Equity – residual interest in the entity's assets

Equity is the interest remaining in the entity's assets after deducting all the liabilities. In other words, the instrument is equity if the entity is not required (but may choose) to pay out cash or another financial asset. For example, an entity issues shares; the dividends are only payable when declared by the board of directors. The entity can pay dividends and can choose to buy back shares (a treasury share transaction). Investors may expect dividends and/or shares to be bought back, but the entity is not obliged to do either. The market may 'punish' a stock that is not paying dividends, but this does not create an obligation. The instrument meets the definition of equity, as the entity has discretion over the dividend payments and it cannot be forced to 'redeem' the shares.

Rules on substance of the contract

The substance of a contractual arrangement determines whether or not the entity is obliged to pay cash. It might make 'sense' for an entity to pay dividends or buy back the instrument, but it is not mandatory. An instrument might have a feature that creates an economic incentive or punishment for the entity to make a payment or redeem the instrument. This 'economic compulsion' is not relevant to the classification as equity or financial liability. For example, an entity issues a preferred share with a fixed dividend of 5% of the face amount that can be deferred indefinitely. The dividend increases to 25% if the entity does not call the instrument by a certain date. The entity may be economically compelled to call the instrument before the date the dividend payment escalates to 25%. However, there is no contractual obligation to exercise the call and redeem the instrument or to pay the higher amount of dividend. The instrument is therefore equity.

* A narrow subset of redeemable instruments can be classified as equity if they meet certain strict criteria. The instrument amongst other criteria must be the most residual instrument that the entity issues. Many instruments that can be put back to the entity for cash are likely to continue to be classified as financial liabilities.

Settlement in shares, not always equity

Instruments are sometimes settled using the company's own shares rather than cash. Even though the company delivers its own shares to settle the instrument, the instrument does not necessarily meet the definition of equity. It is the type of settlement that determines whether or not the instrument is equity. Only instruments that are settled by delivering a fixed number of shares in exchange for a fixed amount of cash meet the definition of equity. This is commonly referred to as the 'fixed-for-fixed' principle.

So, in other words, an instrument is a financial liability if any of the features are present:

- The number of shares to be issued is variable;
- The amount of cash that will be paid is variable; or
- The instrument is settled 'net' (ie, for either cash or shares).

For example, management issues a warrant that allows the investor to receive 100 shares at a an exercise price of C5 per share. The entity is obliged to deliver its own shares when the investor exercises the warrant. This instrument meets the definition of equity because the entity will deliver a fixed number of shares (100) and receive a fixed amount of cash (C500).

Another example is a warrant that can be net settled with shares. That is, if the fair value of the shares at the date of exercise of the warrant is C150 and the exercise price of the warrants is C100, the net difference of C50 is settled in shares. The number of shares will vary according to the fair value of the shares at the date of exercise. The instrument does not meet the fixed-for-fixed principle and is therefore a financial liability.

Instruments with provisions that can adjust the amount of cash or the number of shares to be delivered need to be carefully analysed – they are likely to violate the fixed-for-fixed principle. Settlement choices by either the entity or the investor also fail the fixed-for-fixed principle for equity classification.

Compound instruments

Some instruments are either a financial liability or equity in their entirety, but other instruments may have elements of both. These instruments are referred to as compound instruments; the financial liability and equity component are accounted for separately.

This concept is particularly important when dealing with instruments such as convertible bonds, where the investor is able to convert the bond into shares rather than receive the principal paid in cash upon maturity. The key point with these instruments is to look at each feature and determine the classification of each of the features based on the basic principles described above.

For example, management issues a 10-year convertible bond for C100 million, which pays mandatory interest of 3%. The bond allows the holder to convert the C100 million into ordinary shares at a ratio of 10 shares per C1,000. The bond has two features: (1) a conversion option into shares; and (2) an obligation to pay cash for the interest and principal of the bond (the principal being repaid if the bond is not converted). The bond has characteristics of both a financial liability and equity. The obligation to redeem the bond and the mandatory 3% interest payments are accounted for as a financial liability. The equity conversion option meets the fixed-for-fixed principle, so it is accounted for as equity.

The fair value of the financial liability is determined first, and the residual is recorded as equity. Cash received from the investors less the fair value of the liability equals the equity portion. The liability's fair value is determined by discounting the stream of cash flows using a current market rate for a similar liability that does not have the conversion feature. The concept is to measure what the cost would have been for the financial liability component.

The interest on the convertible instrument in the example is 3%, but a similar instrument without the conversion feature may pay a market rate of 5%. This means that the cash flows would be discounted using the 5% rate. So, if management issued the instrument for C100 million, and the fair value of the liability component is C80 million, the residual is recorded in equity at C20 million. Management will need to accrete the liability component back to its par value of C100 million, so the interest expense recognised in the income statement will be higher than if it had been accounted for as one instrument using the stated rate of interest.

A non-convertible instrument may also have both a debt (financial liability) and an equity component, such as mandatorily redeemable preferred stock that pays discretionary dividends. The mandatory redemption feature is a financial liability and the discretionary payment of dividends is an equity component.

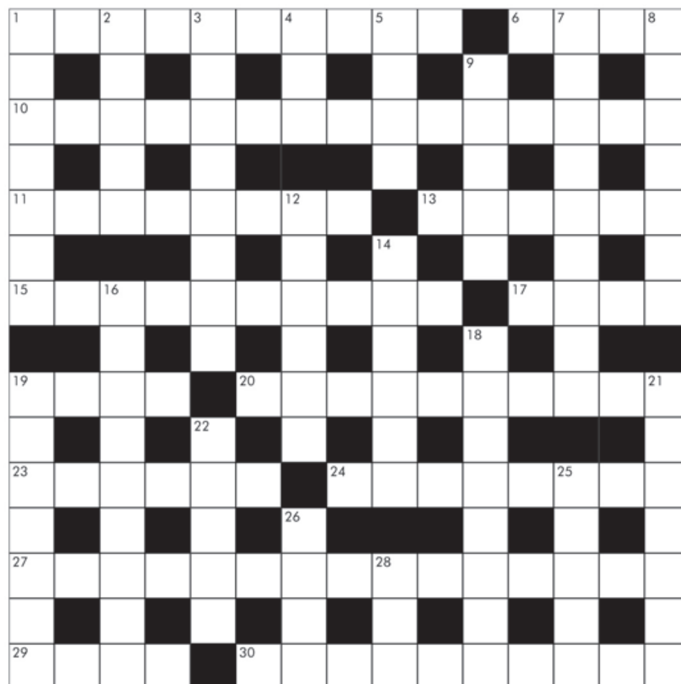
In summary

Classification as a financial liability or equity will have significant consequences for the accounting, calculation of performance ratios and determination of lending covenants. All of the terms and conditions should be carefully considered when classifying an instrument as a financial liability or equity. As with all of the beginner's guides, consultation with an expert is advisable, as many financing arrangements come with different bells and whistles that create complexity and need to be carefully assessed.

Three points to start with when considering classification are:

- A contractual obligation to pay cash, even if contingent on a future event, results in financial liability classification.
- Instruments settled in the entity's own shares are classified as equity only if the exchange results in the delivery of a fixed number of shares for a fixed amount of cash.
- Instruments that contain both financial liability and equity components are accounted for separately.

Crossword



Across
1 Financial instrument whose value is based on another security (10)
6 Operating at a ___, resulting in 1 down (4)
10 One whose business is the management of burial and cremation services (7,8)
11 Profit is an opinion, while this is a fact (4,4)
13 Monetary, of public revenue (6)
15 Napkins, serviettes, etc. (5, 5)
17 As scarce as hens' teeth in the current environment (4)
19 Hundredth part of various monetary units (4)
20 One of the salads eaten in Passover-time in the Old Testament (6,4)
23 Basic functional unit of the nervous system (6)
24 Condemned to misery or destruction (8)
27 Understanding between Britain and France in 1904 (7,8)
29 Lack of something that one really cannot do without (4)
30 Last year's business combination, this year's goodwill ________ (10)

Down
1 Excess of liabilities over assets (7)
2 Rows of soldiers standing side by side (5)
3 Testified and established the truth (8)
4 Sesame, a type grown in India (3)
5 Not binding in law (4)
7 Part of mid-brain that is concerned with sight (5,4)
8 Excess of income over expenditure (7)
9 Pacioli said that for every credit should have one (5)
12 Starting-point from which measurement is made (6)
14 Characterised by extreme activity and excitement (6)
16 Raised step behind a rampart (9)
18 Ball that keeps low (8)
19 See 22 down
21 It is unlikely to be repaid (3,4)
22 & 19 down Successful business activity (5,7)
25 Individual portion of capital stock of a corporation (5)
26 Length of time to repayment of a loan (4)
28 Female reproductive cells (3)

Crossword solutions
Across: 1 Derivative; 6 Loss; 10 Funeral director; 11 Cash flow; 13 Fiscal; 15 Table linen; 17 Jobs; 19 Cent; 20 Bitter herb; 23 Neuron; 24 Accursed; 27 Entente Cordiale; 29 Need 30; Impairment.
Down: 1 Deficit; 2 Ranks; 3 Verified; 4 Til; 5 Void; 7 Optic lobe; 8 Surplus; 9 Debit; 12 Origin; 14 Hectic; 16 Banquette; 18 Grounder; 19 Concern; 21 Bad debt; 22 Going; 25 Share; 26 Term; 28 Ova.

Should you have any technical questions, please do not hesitate to direct these to the following e-mail address: ifrshelpdesk@pwc.be and we will take care of them in the most appropriate way.

For further help you can also contact:

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