IFRS News

Emerging issues and practical guidance*

Issue 68 – November 2008

IAS 39 and IFRS 7 amendments on reclassifications

The Board has issued amendments to IAS 39 and IFRS 7, permitting the reclassification of some financial assets. Jessica Taurae explains.

The amendments published last month address the differences between the reclassification requirements of IAS 39 and US GAAP. They are effective immediately and can therefore be applied for third-quarter results. They were issued as an urgent response to the current financial crisis, with some aspects of due process suspended, with the agreement of the IASCF trustees.

Entities are now permitted to reclassify financial assets classified as held for trading in the following situations only:

- Where the financial asset meets the definition of a loan or receivable at the date of reclassification and the company now has the intent and ability to hold it for the foreseeable future or to maturity; and
- In rare circumstances for other financial assets (ie, those that do not meet the definition of a loan or receivable at the date of reclassification).

The IASB issued a press release announcing the publication of these amendments, the deterioration of the world's financial markets in the third quarter of 2008 are a possible example of these 'rare' circumstances.

The flowchart on page 2 summarises the ability to reclassify under the amendments.

Entities continue to be prohibited from reclassifying derivative financial instruments, non-derivative financial liabilities and financial instruments designated on initial recognition as at fair value through profit or loss out of the fair value through profit or loss category. Any reclassification into the fair value through profit or loss category after initial recognition remains prohibited.

At the date of reclassification, the fair value of any financial asset reclassified under these provisions becomes its new cost or amortised cost, as applicable. The effect of any subsequent increase in the estimated cash receipts of a reclassified asset as a result of increased recoverability of those cash receipts is spread over the life of the asset by adjusting the effective interest rate prospectively. The cumulative catch-up approach in

In this issue...

1 **IAS 39 and IFRS 7 amendments** Reclassification

3 **IFRS 5 amendments** ED on discontinued operations

4 **IFRS 1 amendments** ED for first-time adopters

5 **IFRSs applicable for 2009**

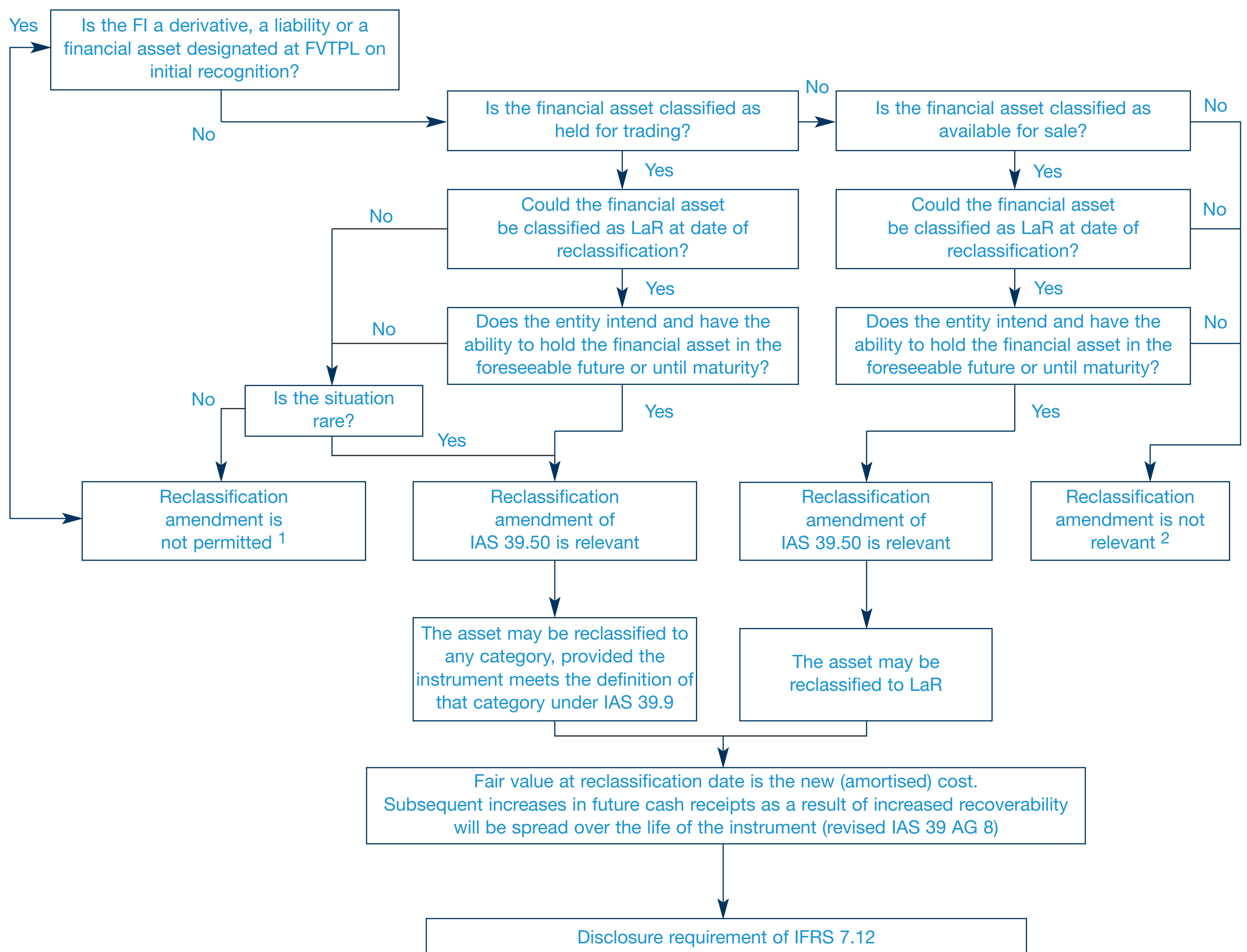
6 **Contacts**

IAS 39 is not applied in these circumstances. The intention of this is to ensure that previously impaired cash flows are reflected in the income statement over the life of the asset rather than as immediate income when expectations improve.

IFRS 7 has also been amended to require extensive disclosure requirements about any assets reclassified as a result of this amendment to IAS 39. In particular, management is required to disclose details of carrying amounts and fair values for all financial assets that have been reclassified until they are derecognised, together with details of the fair value gain or loss that would have been recognised in the income statement or equity if the financial asset had not been reclassified.

The Board clarified that prior to 1 November 2008, entities had the ability to reclassify certain financial assets from 1 July 2008. After 1 November, any reclassification made takes effect from the date of reclassification. Any reclassifications out of held for trading or available for sale made after that date will have to be recognised prospectively. In the meantime, any reclassifications can be back-dated to any date on or after 1 July 2008 if they meet the conditions for reclassification at that date.

Amendment of IAS 39 for the reclassification of financial instruments published in October 2008



[1] See IAS 39.50
[2] See IAS 39.51-54 for guidance on reclassification

ED amendments to IFRS 5

IFRS 5, 'Non-current assets held for sale and discontinued operations', was issued in 2004 as the result of a short-term convergence project between the IASB and the FASB and substantially achieved that objective. However, IFRS 5 was issued with a different definition of a discontinued operation from the US standard, as the two Boards were unable to agree on a definition. Four years later, the IASB has set out to finish where it left off through the revised IFRS 5. Yvonne Kam and Anuj Puri of PwC's Global Accounting Consulting Services in Hong Kong explain.

The ED appears to be a step towards simplifying IFRS 5 and making it more user-friendly, both for preparers as well as users. The main proposals are outlined below.

Operating segment as criterion for 'discontinued operation'

The IFRS 5 exposure draft proposes to use an operating segment (as defined in IFRS 8, 'Segment reporting') as the criterion to determine whether a component of an entity that has been disposed of or classified as held for sale should be presented as a discontinued operation. This is the most fundamental of the changes being proposed.

Some users have indicated to the Board that a disposal activity should be presented as a discontinued operation only when there is a 'strategic shift' in an entity's operations. The Board considers the best way to achieve this is to align the identification of discontinued operations to IFRS 8, given the strategic thrust inherent in identifying operating segments by the chief operating decision-maker (CODM). The Board also believes that subjectivity would be eliminated by removing terms like 'major line of business' and 'geographical area' from the previous definition. The amended definition will simplify the overall determination of discontinued operations, as entities are already required to identify operating segments under IFRS 8.

The determination of operating segments under IFRS 8 will therefore be critical; management should be mindful of the interaction of IFRS 8 with other standards such as IAS 36.

Relevant IFRSs drive measurement and disclosure

The ED also proposes that amounts presented as discontinued operations are based on relevant IFRSs (ie, based on relevant IFRSs, even though the classification of a component as a discontinued operation is based on operating segments). These amounts may not necessarily be the same as amounts presented in an entity's segment analysis, which are typically based on the CODM package. For example, management might not pay close attention to the measurement of items like deferred taxes or fair value measurements for assets and liabilities, for the purposes of segment analysis. However, when considering disclosure requirements from an IFRS 5 perspective, the measurement and recognition requirements of respective IFRSs still apply. This means that management may have to gather additional information concerning operating segments in order to comply with disclosure requirements for discontinued operations.

Major items to be disclosed and reconciled

The Board is proposing an amendment that will require entities to disclose major items of income and expense and major classes of assets and liabilities for discontinued operations and to reconcile these amounts (presented in the notes) to amounts presented on the face of the financial statements. The Board believes that in the absence of such a reconciliation, users might attempt to reconcile these numbers on their own, and this might be counter-productive. This requirement will not be burdensome given that the information would be readily available, but management will need to bear this in mind when preparing note disclosures in respect of discontinued operations. Only minor items will be allowed to be aggregated in reconciling these amounts. Determining what might be minor may be subjective, and some judgement will need to be exercised. Items that would normally be presented separately will include impairments, interest, depreciation and amortisations.

Acquisition of a business

A further proposed amendment concerns the acquisition of a 'business' (as defined in IFRS 3 (Revised)) that meets the IFRS 5 criteria to be classified as held for sale on acquisition. The earlier definition referred to a 'subsidiary', as opposed to a 'business'. Current IFRS 5 does not require note disclosures for subsidiaries that meet the held-for-sale criteria on acquisition. Providing note disclosures for such entities could mean obtaining significantly more information, which could be an onerous task. The Board believes that the exemption from disclosures should apply to a business regardless of the legal form of the transaction – clearly a reasonable approach.

Comments on the exposure draft are due by 23 January 2009.

ED of amendments to IFRS 1: additional relief on adopting IFRS

The IASB has published a short exposure draft proposing additional accommodations for first-time adopters of IFRS. Michael Stewart provides an overview.

The general principle for entities adopting IFRS is to prepare their financial statements as if the entity has always applied IFRS. IFRS 1, 'First-time adoption of IFRS', provides optional exemptions and mandatory exceptions from this general principle. The new proposed optional exemptions relate to:

- Full-cost accounting by oil and gas entities;
- Accounting for property, plant and equipment (PPE) by rate-regulated entities, such as utilities; and
- Determining whether arrangements contain a lease.

Full-cost accounting

An entity that applies full-cost accounting under previous GAAP accumulates costs for its development and producing oil and gas properties in large geographical cost pools, often a single pool for a continent. This level of cost accumulation is incompatible with the component approach to depreciation and the CGU-level impairment testing under IFRS. Allocating the costs from the full-cost pools to an appropriate level (say, groups of wells in a field) on a specific identification basis can be a challenge, if the costs have been accumulated over many years. The proposed exemption allows a first-time adopter to allocate the costs from its full-cost pools to individual oil and gas fields on the basis of the oil and gas reserve volumes or values relating to those fields. The ED does not specify whether an entity choosing to allocate costs using reserve values should use fair value or some other measurement basis.

The first-time adopter should test the costs relating to fields in the development or production stages for impairment on a CGU basis (typically at the field level) in accordance with IAS 36, 'Impairment'.

The decommissioning provision related to each field is measured at transition date in accordance with IAS 37, 'Provisions, contingent liabilities and contingent assets'. However, the corresponding entry is adjusted against opening retained earnings when the exemption for full-cost accounting is used, rather than adjusting the carrying amount of the related PPE.

Rate-regulated entities

Some entities in rate-regulated industries such as electricity were permitted to capitalise costs within PPE under previous GAAP on the basis of agreement with the regulator. Some of these costs would not qualify for capitalisation as components of PPE in accordance with IAS 16, 'Property, plant and equipment'. The proposed exemption allows a first-time adopter to retain the previous GAAP carrying amount as deemed cost on transition to IFRS. However, the proposed exemption is not a free choice; it is only available if restatement in accordance with the other requirements of IFRS 1 is impracticable.

A first-time adopter that applies this exemption should test the PPE for impairment at transition date in accordance with IAS 36. The decommissioning provision related to the PPE is measured at transition date in accordance with IAS 37. However, the corresponding entry is adjusted against opening retained earnings when the exemption for rate-regulated entities is used, rather than adjusting the carrying amount of the related PPE.

Determining whether an arrangement contains a lease

IFRIC 4, 'Determining whether an arrangement contains a lease', is applied to contracts at transition date on the basis of the facts and circumstances at that date. National GAAP in some countries had similar requirements to IFRIC 4, and entities had to make a similar assessment of whether a lease existed and then classify it as finance or operating. A first-time adopter that made this assessment under national GAAP at an earlier date does not need to reassess at transition if it applies this exemption. However, the similar requirements under both US and Canadian GAAP were applied prospectively to new arrangements. Thus, without any further relief, entities will need to look at these older arrangements under IFRIC 4.

All of the proposals will be of particular interest to companies in Canada that are transitioning to IFRS in 2011. Use of full-cost accounting is widespread in the oil and gas industry under Canadian GAAP, much of the utility sector is in a cost-plus regulatory regime, and there was an equivalent of IFRIC 4. Comments on the exposure draft are due by 23 January 2009.

IFRSs applicable for 2009

The Board has had a busy work programme over the last few years. It has issued a number of new standards and interpretations, and amendments to existing standards, including those resulting from its annual improvements project. Many will be effective for 2009 with earlier application permitted. Early adopters should be aware that there may be consequential amendments that affect the disclosure requirements of other standards.

PricewaterhouseCoopers' is publishing guidance on the new requirements next month. *A practical guide to new IFRSs for 2009* outlines some of the key implications for management, in Q&A format. These new/amended standards and interpretations are listed below.

New standards and amendments effective 1 January 2009

- IAS 1 Revised, 'Presentation of financial statements';
- IAS 23 Revised, 'Borrowing costs';
- IAS 32 and IAS 1 Amendment, 'Puttable financial instruments and obligations arising on liquidation';
- IFRS 1 and IAS 27 Amendment, 'Cost of an investment on first-time adoption';
- IFRS 2 Amendment, 'Vesting conditions and cancellations';
- IFRS 8, 'Operating segments'; and
- IFRIC 15, 'Agreements for the construction of real estate'.

Amendments from May 2008 Annual Improvements project effective 1 January 2009

- IAS 1, 'Presentation of financial statements';
- IAS 16, 'Property, plant and equipment';
- IAS 19, 'Employee benefits';
- IAS 20, 'Government grants and disclosure of government assistance';
- IAS 23, 'Borrowing costs';
- IAS 27, 'Consolidated and separate financial statements';
- IAS 28, 'Investments in associates';
- IAS 29, 'Financial reporting in hyperinflationary economies';
- IAS 31, 'Interests in joint ventures';
- IAS 36, 'Impairment of assets';
- IAS 38, 'Intangible assets';
- IAS 39, 'Financial instruments: Recognition and measurement';
- IAS 40, 'Investment property'; and
- IAS 41, 'Agriculture'

An overview of the implications of amendments from the Annual Improvements project is also provided in June 2008 supplement to *IFRS News*.

Amendments effective 1 July 2009

- IAS 27 Amendment, 'Consolidated and separate financial statements';
- IFRS 3 Amendment, 'Business combinations and consequential amendments';
- IAS 39, 'Financial instruments: Recognition and measurement – Amendments for eligible hedged items'; and
- IFRS 5, 'Non-current assets held for sale and discontinued operations' (May 2008 Annual Improvements project).

Management is advised to start assessing the implications of these new standards and amendments now and consider the merits of early adoption. Planning early will allow time to prepare any new data.

A practical guide to new IFRSs for 2009 will be available to order or download from the website www.pwc.com/ifrs from December 2008.

Publisher's note: beginners' guide to deferred tax

Apologies to fans of our beginners' guide series; we had intended to publish the beginners' guide to deferred tax this month, but explaining IAS 12 in simple terms is like describing the Viennese waltz as a country dance done in 3/4 time. In fact, the simplest encyclopaedia definition of the Viennese waltz runs to over 500 words. But we are rising to the challenge of distilling over 50 pages of IAS 12 into two or three pages of guidance in layman's terms, and will publish the next in the beginners' guide series in the December edition of *IFRS News*.

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