# IFRS News

Shedding light on the IASB's activities*

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## In this issue…


1 **IAS 32 amendment** Puttable instruments

2 **IFRIC D23** Distributions of non-cash assets to owners

3 **Roundtable discussion** Financial instruments

6 **IFRS or not?** IOSCO urges clarification

7 **IVSC** Trustees appointed

7 **Contacts**


Issue of the month

PRINT CONTINUED

# Amendment to IAS 32 dealing with puttable instruments

**The IASB published an amendment to IAS 32 *Financial Instruments: Presentation* and IAS 1 *Presentation of Financial statements*, on 14 February 2008 after a long waiting period. Fredré Ferreira, senior manager with UK ACS looks at the changes and their impact.**

The amendment to IAS 32 *Financial Instruments*: *Presentation* and IAS 1 *Presentation of Financial Statements* is the outcome of the Board's earlier commitment to improve the relevance and understandability of the current accounting treatment for these instruments. The amendment is effective for year-ends commencing on or after 1 January 2009 with earlier adoption allowed. EU listed companies will have to wait for endorsement by the European Commission before they can adopt the amendment.

The impact of the changes will be most significant for entities structured as co-operatives or partnerships. Some investment funds may also be affected to a limited extent. The amendment changes the classification of certain qualifying instruments from financial liabilities to equity instruments. These instruments will no longer have to comply with the measurement requirements of financial liabilities in IAS 39, *Financial Instruments: Recognition and Measurement*, or the disclosure requirements of IFRS 7, *Financial Instruments: Disclosure*. Constituents argued that these instruments often represent a residual interest in the entity, and as such meet the definition of equity – despite the inherent obligation to pay cash. The Board were persuaded to amend IAS 32.

The amendment deals with puttables, i.e. financial instruments that the holder of an instrument has the option to sell back to the entity, or those that have to be put back on an uncertain event such as death or retirement. It also deals with instruments that include a contractual obligation for the issuing entity to make a payment on liquidation, where liquidation is certain to occur (i.e. a limited life entity) or liquidation is at the option of the instrument holder.

To qualify for equity classification in the separate financial statements of the issuer the instrument must meet a number of stringent criteria:

- It must be in the most subordinated class of instruments, and all instruments in that class must have identical features. *Preference* shares do not meet this requirement and therefore continue to be classified as liabilities. In the event of liquidation, the holder must receive a pro rata share of the entity's remaining assets once the liabilities are repaid.

- It must share in the performance of the entity, either with reference to its profits or losses, or its net assets.
- No other instrument should share in the performance of the entity in a similar way, and the puttable instrument's return should not be fixed or restricted by another instrument.
- A puttable instrument should not (apart from the put feature) have any obligation to pay cash or another financial asset, to be exchanged under potentially unfavourable conditions or to be settled in a variable number of shares.

Similar criteria exist for instruments issued by limited life entities.

The Board clarified that this is a narrow exception and should not be applied by analogy. Furthermore, a qualifying instrument would not be considered an equity instrument under another standard such as IFRS 2, *Share-based Payment*. The equity classification of instruments issued by a subsidiary would not flow through on consolidation as these instruments are not considered to be the most subordinated class on consolidation. This also limits accounting arbitrage and structuring opportunities.

The impact of the amendment will vary between territories and industries depending on the specific structures in use.

# IFRIC D23: Distributions of non-cash assets to owners

**The IFRIC has published a draft interpretation providing guidance on how to account for non-cash distributions to the owners of an entity. Michael Stewart, director in PwC's Global ACS Central team, looks at the proposals.**

The draft interpretation would apply when an entity declares a dividend to a class of shareholders to whom it will distribute non-cash assets. Examples of such assets are property, plant and equipment and shares in another entity. It also applies to situations where the shareholder has the choice of receiving either the non-cash asset or a cash alternative. However, the interpretation will not apply to distributions to a parent company of the entity, i.e. transfers of non-cash assets within a group are outside the scope of this interpretation. The interpretation will not apply to distributions in which shareholders of a particular class are not treated equally.

The approach that the interpretation takes is to provide guidance first on the recognition of a liability for the dividend payable, including subsequent measurement. It then provides guidance on how to account for the difference (if any) between the carrying values of the asset distributed and the liability when the distribution is made.

The draft interpretation proposes that a liability for a dividend declared is recognised in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* with the corresponding reduction in shareholders' equity recognised in the statement of changes in equity. The liability is measured at management's best estimate of the amount the entity would have to pay to settle the obligation at the balance sheet date or to transfer it to a third party. The draft interpretation says "an entity shall consider the fair value of the asset to be distributed", when discussing measurement of the liability. However, it does not seem to explicitly require the liability to be measured at fair value although this seemed to be the conclusion reached by the IFRIC in their November 2007 meeting. The draft interpretation goes on to explain that when a cash alternative is offered, management is required to estimate the proportion of shareholders that will accept each alternative when measuring the liability. Subsequent measurement of the liability is recorded as an adjustment to the distribution in the statement of changes in equity.

Settlement of the obligation results in derecognition of the assets distributed and derecognition of the liability that is settled. Differences (if any) in the carrying amount of the assets distributed and the liability settled are recognised in the income statement. This difference will reflect a holding gain that the entity has accrued during its period of ownership of the asset. Recognising this holding gain in the income statement reflects the effects of the transaction from the entity's perspective. It also provides a transparent reflection of the distribution that will be particularly relevant to other classes of equity owner and to other parties that have a claim on the assets of the entity, for example finance providers. However, distributions in which shareholders of a particular class are not treated equally are perhaps in greater need of transparent disclosure and yet these distributions are excluded from the scope of the interpretation.

Recognising a liability for a distribution of non-cash assets at fair value and the subsequent gain on settlement in the income statement is expected to be a change in accounting for many entities. Historically, many entities have recorded the liability for a non-cash distribution at the carrying amount of the asset, thus no gain was recognised when the distribution was made. An example of the applicability of the interpretation will be when a group spins off a division or other self-contained part of its business to its shareholders by distributing shares in the spun-off business in proportion to their ownership interest in the existing parent entity.

The comment period closes on 25 April.

# Roundtable discussion on financial instruments

Four partners in PwC's Financial Instruments topic team discussed some of the key IFRS issues facing companies in this accounting area. Highlights of this roundtable discussion – covering financial instruments and related projects, debt/equity, IFRS 7, IFRIC 12, and the designation of hedging relationships – are reproduced below.

**IF (Ian Farrar): Financial instrument-related issues are often cited as being particularly complex. Which cause the most headaches in your territory?**

**RF (Regina Fikkers):** Debt/equity issues, particularly where we see private equity issuers creating complex instruments with unintentional accounting consequences. The common example is where companies have embedded derivatives in their instruments caused by too many alternatives in the conversion terms.

**IF:** That's consistent with Hong Kong and China where seemingly innocuous changes to terms of convertibles often have fundamental implications for the accounting.

**MK (Marie Kling):** The other issues related to the area of debt/equity are contingent settlement features and the liability classification that results from these. We also get questions around puttable instruments and the related liability classification, particularly in a fund environment; the recently-issued amendment to IAS 32 will allow some of these instruments to be classified as equity going forward. Derecognition (transfers of financial assets) also causes headaches because of the difficulties in applying the IFRS model, which is very different from the U.S. model.

**BR (Bernd Roese):** In Germany it's also debt/equity classification but also where there are financial instruments driving a consolidation decision of a SPE under SIC 12. People look at the risks and rewards assessment but the list of indicators in SIC 12 is longer than that. They need to look at the full picture and the substance of the transaction that drives the conclusion. In particular, they should ask: "for whose purpose has it been set up?", and "what is the decision making process?". These questions can be just as relevant as the risk and rewards assessment.

**IF: Both the IASB and IFRIC have projects covering financial instruments and related areas. Which do you see as bringing the greatest improvement to financial reporting?**

**MK:** The debt/equity project should bring significant improvement in terms of looking at the overall conceptual model and making sure some of the counter-intuitive results that come out of the application of IAS 32 don't happen in the future. I'm also looking forward to convergence on fair value measurements. The new US standard is different in some respects from IFRS and it's very difficult to explain to a user of financial statements that what's "fair" on one side of the Atlantic is "not fair" on the other side of the Atlantic.

**RF:** I see the insurance project as a good step forward in creating consistency in financial reporting. It is also a good example of the IASB trying to understand the needs of analysts and users of the information right at the design stage.

**BR:** Repeating what Marie said, I think the debt/equity project could bring significant improvements and I see it as one of the most important projects in the financial instruments arena.

**IF: What about the leasing project? Is the existing model broken and in need of repair, or do preparers and users appreciate the comfort-factor of the existing model, as might be associated with a pair of well-worn shoes?**

**BR:** The standard needs improvement from a conceptual standpoint; the model is inconsistent with the recognition of assets and obligations in other standards. However, users and preparers are used to the current leasing standard, so I would probably place other items higher on my list of priorities for the German marketplace.

**IF:** When we talk to analysts here, they often include operating lease obligations as liabilities when calculating gearing ratios. I therefore see this as an opportunity to give users information that they believe is important. However, the leasing industry in the US is huge – a large part of that is involved in structuring to keep leases off balance sheet. How will the US react to a new standard that is expected to bring lease liabilities on balance sheet?

**MK:** This is a joint project with the FASB. The SEC and others are concerned that lease accounting allows financing to be off balance sheet. In the US the current position is even worse as US GAAP has a bright line and the literature is very specific. So while I agree that people are used to applying the leasing model in practice, I believe that this is a priority item for the two Boards.

**IF: Concerns were raised earlier about the complexities of the existing debt/equity model. The liabilities and equity project currently being undertaken contains three models, each of which has its own problems. What would you recommend if you had a free rein?**

**MK:** I like IAS 32 because it has simple definitions of a liability and equity compared to the various sources of literature under US GAAP, but unfortunately it isn't always intuitive and causes quite a few application issues. I would like to see the new

model better reflect the economics of the instruments so that you get an instrument that everybody believes is a liability (and is priced as such), ultimately being classified as a liability from an accounting perspective.

**RF:** I like the idea of classifying instruments on the balance sheet by order of liquidity, but perhaps that's too simple for today's world. The basic approach may be too strict and the reassessed expected outcomes approach may end up being impractical. I think the pragmatic solution will be something similar to IAS 32, but better defined. Perhaps the ownership settlement approach is the beginning of this.

**BR:** I think the challenge of IAS 32, and any new standard from an accounting perspective, is the need for an economic model to define equity. In many territories this becomes a legal issue, and it can be a huge challenge. I would like to see an amendment that relates the puttable instrument to the residual interest, and the cash flows to performance. That might give some problems if we don't know what caused the performance of the entity though.

**IF: The claims approach idea that Regina referred to, where items are presented in order of seniority, is great from a presentational point of view, but wouldn't that give us a problem for measurement? Would you change the measurement for liabilities or would you be happy to remeasure your equity for each period?**

**BR:** My view is that any model proposed needs to reach a point where the measurement changes from fair value or amortised cost to no re-measurement, and the distinction needs to be clear.

**IF:** What's becoming clear is that this is a very difficult topic and there's unlikely to be an answer that pleases everybody.

**IF: Many preparers are required to apply IFRS 7 for the first time in December 2007. How ready are companies in your territory, and which of the requirements cause most difficulty in practice?**

**BR:** My impression is that most companies are very well prepared, and I think that's because they've had sufficient time to adopt the standard. Intensive discussions in Germany revolve around the relationship between IFRS 7 and IFRS 5, particularly where companies don't want to give any IFRS 7 disclosures on financial instruments held in discontinued operations. I can understand this because it makes limited sense to give forward-looking prospective information on long-term financial instruments likely to be disposed of within a short period of time as part of the discontinued operation, but there's currently no explicit scope for exclusion in IFRS 7.

**RF:** The first challenge is where receivables are one day overdue they are classified as past due, but not impaired. As an example, companies may quote terms of 14 days to prompt their customers to pay within 30 days. IFRS 7 requires disclosure of the fair value of collateral on such debts, which is a challenge to obtain. That's an interesting issue for companies because the Basis for Conclusions is different to the Standard in determining what's impracticable, so it is causing some confusion. The standard is clear that you need to try and work out the fair value so clients need to do the work to establish that.

**MK:** For many companies, it's a change in mindset. IFRS 7 puts more focus on disclosures surrounding how an entity manages financial risks and the nature of those risks. Getting companies to think about those issues and use the IFRS 7 disclosures to communicate them to investors can be quite a significant effort.

**IF:** You are absolutely right about the mindset. We have had to apply IFRS 7 to a number of IPOs in Hong Kong and China throughout 2007, so we have seen it applied early. A very common issue is that companies are not used to explaining what they do, particularly regarding interest rate risk. However, it is usually a conscious decision to elect floating rate debt (and hence cash flow interest rate risk) or fixed rate debt (and hence fair value interest rate risk). The thought process is how they manage the risk. Companies have a tremendous opportunity to use IFRS 7 disclosures to give positive messages regarding their risk management processes.

**RF:** For me it's not about the amount of disclosures but the quality of what's given. In the past we may have seen lots of disclosures but the quality was hidden in the detail. IFRS 7 should be seen as a great opportunity to get the right messages out to the market.

**IF: IFRIC 12 applies for the first time in 2008 for calendar-year companies. What do you expect to be the greatest change for companies in your region?**

**IF:** The government in China is involved in the provision of a broad range of services to the public. The lines can become blurred regarding whether a state-controlled entity is an extension of the government or is acting as a corporate. When is an entity private, public, or semi-public, and what does that mean in terms of the scope of IFRIC 12?

**BR:** In Germany, companies are already considering the implications of IFRIC 12 even though it's not yet endorsed for use in the EU. Typically, service concession agreements would have been shown as either PP&E or leasing, depending on how they were structured. Companies will now have to

report them in different items – either financial instruments or intangibles – and for many preparers and users this will be a great shift.

**RF:** In the Australian context we have examples of companies accounting for these types of arrangement with financial instruments and others who use intangible assets, so it's not necessarily new but it's broadening the scope. I suppose it's about how to provide consistency across a broader range of entities that might have accounted for them in different ways.

**IF: The designation of the hedging relationship is key to achieving an effective hedge under IAS 39. Many have found this a challenging area, and the IFRIC have been asked on many occasions to interpret what can be designated as a hedged item, or to provide additional guidance on effectiveness tests. Do you see difficulty implementing the standard as it's written now? Do you think the ED on portions helps with any of these?**

**RF:** We saw a lot of issues on transition to IFRS but most companies are now comfortable with their hedging, so the questions have died down. What we are now finding as an area of difficulty is net investment hedging and unwinding of net investments and disposals, because that's the next phase of transactions.

**MK:** There will always be issues in practice because transactions evolve and some of the more sophisticated companies come up with new strategies for improving their existing hedging practices. What is unfortunate about the ED on portions is the provision of examples of what does and doesn't work. This is very difficult in practice because people then argue endlessly about items that are not on the list. This is part of the broader issue of principles versus rules, and the use of judgment in the application of principles.

**BR:** My biggest concern, because it's one of our hot topics, is that hedging of portions of non-financial items is very limited. Due to the increasing volatility in raw material prices, more companies are thinking about how to hedge their respective exposures and to achieve hedge accounting under IAS 39.

**IF:** That is an issue for us too. We see a lot of commodity-related issues that cannot be hedged effectively; for example where a commodity is priced based upon a commodity index plus variable transportation costs. The variability in shipping costs can cause the designation to fail.

**IF: Do you see a lot of companies electing not to hedge account for their offsetting positions? Has the inability to hedge account influenced the commercial strategy in your region?**

**RF:** We do have evidence of companies saying "hedge accounting is too complex, let's take the volatility", but less so at the higher end of the market where companies have the resources to cope. People are still doing business the way they were before. The accounting will never change the cash, but having to explain the volatility can be difficult.

**MF:** I agree. It's all about getting a better income statement result.

**BR:** I have seen smaller companies decide not to apply hedge accounting but only in situations where they didn't have many derivatives and can live with the volatility in the profit or loss statement. When I'm talking to clients I always tell them to look at the message they give to the market about their risk management when they disclose that they don't hedge account because they don't have the documentation.

**MK:** Some companies in the US, because of the complexities of the models and the restatements in that area, no longer want to hedge account.

**IF:** Our experience is probably the opposite of the US. IFRS doesn't have the short-cut method, and hence effectiveness testing can be seen to be more challenging. We saw companies opting out of hedge accounting when they first adopted IAS 39 in 2005 because they thought it was too difficult to meet the requirements. Now, increasing numbers are saying they really want to look at this area again, and are asking our advice.

## Participants

- **Ian Farrar,** Global Accounting Consulting Services, Hong Kong/China (IF)

- **Regina Fikkers,** Global Accounting Consulting Services, Australia (RF)

- **Marie Kling,** Global Accounting Consulting Services, United States (MK)

- **Bernd Roese,** Global Accounting Consulting Services, Germany (BR)

# IOSCO urges public companies to clarify use of accounting standards

**Last year, both the IASB and IAASB (International Auditing and Assurance Standards Board) issued exposure drafts with proposals to address financial reporting and audit reporting implications when a jurisdictional version of IFRS is not quite IFRS (IAS 1 and ISA 700). Although neither Board has yet completed their deliberations on the consultations, PwC and others questioned whether the solution rests with accounting and auditing standards, or whether a regulatory response was needed.**

Diana Hillier, Partner, PwC Global Assurance Standards, explains "Highlighting differences between IFRS as applied in those financial statements and IFRS as published by the IASB is undoubtedly useful information for investors. However, we were concerned that such a requirement can only be effectively implemented and enforced by the regulatory authorities who determine the financial reporting framework to be used and disclosures made in the financial statements used in their jurisdiction."

On 6 February 2008, IOSCO issued a statement urging publicly traded companies to provide investors with clear and accurate information on the accounting standards used in the preparation of their accounts.

In the press release, Michel Prada, Chairman of the IOSCO Technical Committee, said:

"IOSCO is concerned that, with the convergence of global accounting standards, investors may assume that all company accounts are generally comparable, even when they are prepared in accordance with quite different generally accepted accounting principles (GAAPs). This commonly occurs where national standards assert that they are based on but do not fully implement International Financial Reporting Standards (IFRS)."

The IOSCO statement explains that they believe the risk of misunderstanding can be mitigated by making sure the information regarding the company's accounting policies and the reporting framework on which they are based is fully and appropriately described in the financial statements. IOSCO also believes it is important that investors and other users can readily get access to the accounting standards and other authoritative literature that underpin a company's accounting policies.

IOSCO is recommending that all publicly traded companies include information that clearly explains the basis on which their accounts have been prepared. In particular, the Statement recommends that companies preparing annual and interim financial statements on the basis of national standards that are modified or adapted from IFRS should include at least the following statements:

- A clear and unambiguous statement of the reporting framework on which the accounting policies are based;
- A clear statement of the company's accounting policies on all material accounting areas;
- An explanation of where the accounting standards that underpin the policies can be found;
- A statement that explains that the financial statements are in compliance with IFRS as issued by the IAASB, if this is the case; and
- A statement that explains in what regard the standards and the reporting framework used differs from IFRS as issued by the IASB, if this is the case.

Diana Hillier notes, "This is a welcome development. It's not the end of the road as it is now important that regulators at a national level implement the recommendations. But the statement shows that securities regulators recognise the issue and are prepared to play their role in finding a solution in the best interests of investors."

# New trustees at IVSC

**PwC partner Jens Røder has been appointed to the interim board of trustees of the International Valuation Standards Committee (IVSC).**

Mr Røder, senior partner PwC Denmark, is a former Trustee of the International Accounting Standards Committee Foundation, and acts as senior adviser to the IASCF trustees on IFRS implementation in Europe.

The IVSC has appointed an interim board of trustees to oversee a restructuring that will enable it to become an independent standard setting body for the development of International Valuations Standards for assets and liabilities.

Mr Røder commented:

"There is growing recognition that there needs to be a comprehensive single set of global standards dealing with valuation procedures to ensure consistency of application and to enable greater reliance to be placed on valuations across borders. This will help ensure conformity for those using valuations for investment decisions, risk profiling, or disclosure in financial statements."

Members of the IVSC interim board of trustees are:

- **Roel C Campos**, Partner in Charge, Washington DC office, Cooley Godward Kronish
- **Christopher Jones**, CBE, Senior adviser at Lazard; member of the joint ventures board of Bank of Scotland and chairman of Henderson Global Property Companies Ltd
- **Jean-Florent Rérolle**, managing director, Houlihan Lokey Howard & Zukin and co-head, Financial Advisory Services in Europe. Chairman Société Française des Evaluateurs
- **Jens Røder**, senior partner, PricewaterhouseCoopers Denmark
- **Michael Sharpe**, director of the Australian Securities Exchange and Babcock & Brown Limited
- **Joseph J Vella**, president of Hendricks, Vella, Weber & Williams, California
- **Zhigang Zhu**, Vice-Minister, Chinese Ministry of Finance.

The interim board of trustees will provide an independent oversight and monitoring role of the IVSC restructuring process announced in November 2007. It will also act as the nominating committee to select the IVSC Trustees and members of the International Valuation Standards Board to allow the new structure to become operational by May 2008.

Commenting on his appointment, Jens Røder said:

"I am pleased to have been asked to join this high profile interim board of trustees and look forward to working alongside colleagues with the breadth of global experience in regulatory, finance, standard-setting, valuations and governmental roles that they possess. I am confident that we will achieve our goal of developing robust and transparent procedures for performing international valuations on the basis of a single set of globally recognised valuation standards that will be acceptable to the world's capital markets."

## For further please contact:

Yves Vandenplas, Partner, Head of the IFRS conversion team: Tel. +32 2 710 4029; yves.vandenplas@pwc.be

Patrice Schumesch, Global Accounting Consulting Services Partner: Tel. +32 2 710 4028; patrice.schumesch@pwc.be

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