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IFRS News

Shedding light on the IASB's activities*

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In this issue

ED on exposures qualifying for hedge accounting

The IASB issued the exposure draft 'Exposures Qualifying for Hedge Accounting' last month. Scott Bandura of the PwC Global ACS Central team and Sandra Thompson of the PwC UK ACS team look at the proposals.

The proposed amendments to IAS 39 are intended to clarify what risks and portions of risks can be designated as a hedged item in a hedge accounting relationship.

Hedging one-sided risks with options

Most of the proposals in the exposure draft are in line with current practice, but there is one area in which a significant change is proposed: hedging one-sided risks of forecast transactions with options.

IFRIC was previously asked whether, in a hedge of one-sided risk, it is possible to designate as the hedged item changes in the cash flows of a hypothetical written option. The IFRIC tentatively concluded that IAS 39 does not permit such an approach and published a tentative agenda decision to this effect. However, it later decided to withdraw the tentative agenda decision pending the publication of the Board's exposure draft.

The exposure draft attempts to confirm IFRIC's previous decision. If this aspect of the modifications to IAS 39 is confirmed, it is likely to lead to recognition of ineffectiveness or disqualification of certain hedges of one-sided risks that entities have currently designated.

Hedging portions of financial instruments

IAS 39 currently permits an entity to 'carve' a financial instrument into portions for hedging purposes and designate a portion of cash flows or fair value of an instrument as a hedged item. This might be, for example, eliminating cash flow risk for floating-rate LIBOR debt only for changes in the risk-free interest rate. Hedging a portion of a financial instrument can be useful because an entity can designate a portion that matches the risks that are hedged in a derivative. This helps to reduce ineffectiveness. Assume an entity is hedging a LIBOR floating debt with a derivative with payments linked to changes in the risk-free interest rate. By designating as the hedged item the portion of the debt that is exposed to risk-free interest rates, potential ineffectiveness that could arise due to changes in the credit risk of the borrower is eliminated.

Hedging portions of financial instruments was common in practice, but IAS 39 contained little guidance on exactly what portions of a financial instrument were eligible for hedge accounting.

The exposure draft only considers portions of financial instruments within the scope of IAS 39. It does not extend to non-financial hedging relationships such as hedges of forecast purchases or sales. IAS 39.82 indicates that the only risk that can be 'carved out' of a non-

PRINT CONTINUED

financial hedged item is foreign currency risk.

The exposure draft clarifies that risks eligible for hedge accounting relating to financial instruments are:

- interest rate risk,
- foreign currency risk,
- credit risk,
- prepayment risk, and
- risks associated with the contractually specified cash flows of a recognised financial instrument.

It proposes that the following portions of financial instruments can be hedged:

- the cash flows of a financial instrument for part of its time period to maturity;
- a percentage of the cash flows of a financial instrument;
- the cash flows of a financial instrument associated with a one-sided risk;
- contractually specified cash flows of a financial instrument that are independent from the other cash flows of that instrument; and
- exposure to changes in the risk-free interest rate or a benchmark rate such as LIBOR.

The amendment is to be applied retrospectively. No effective date has been proposed, but the comment deadline of 11 January 2008 means it is unlikely to be effective in the first half of 2008.

ED 9 – Joint Arrangements

The IASB published ED 9, Joint Arrangements, last month. If approved, it will replace IAS 31, Interests in Joint Ventures. The ED is published as part of the IASB's convergence project with the US FASB. No changes are currently planned for US GAAP, and the ED describes the objective as to 'converge in principle' with US GAAP.

The stated objective of the ED is to require parties to a joint arrangement to account for the rights and obligations that arise under the joint arrangement. The joint parties may have rights to the assets or output of the joint venture and obligations to pay its liabilities. The parties to the joint arrangement recognise their share of those assets and liabilities. An interest in the net outcome of a joint arrangement is accounted for using the equity method.

Little or no change is proposed to the accounting for joint operations or jointly controlled assets. There is more likely to be change where a joint arrangement will include a combination of rights and obligations to specific assets and liabilities, and an interest in the net outcome. An entity that is a party to the joint arrangement will account for its share of those assets and liabilities to which it has rights and obligations. It will also equity account for its remaining interest in the joint arrangement.

The effect of the proposals is to remove the accounting policy choice that exists in IAS 31 of accounting for jointly controlled entities by proportionate consolidation or equity accounting. It also places greater emphasis on the rights and obligations of the party to the joint arrangement rather than focusing on the legal structure of the joint arrangement.

The comment deadline is 11 January 2008. The IASB anticipates the IFRS will be published in the second half of 2008. The effective date is yet to be determined.

Experiences of secondee to IASB

Michael Stewart, a director in the firm's Global Accounting Consulting Services (central team), returned to PwC from a four-and-a-half month secondment to the IASB last month. He talks to *IFRS News* about his role as project manager for the Board's Annual Improvements project and his experiences at the standard setter.

What motivated you to take a secondment with the Board?

It had been a goal of mine for a while to work at the IASB. I knew it would be interesting to be part of the standard-setting process, working with staff and Board members and getting to know them and how the standards are created.

The Board needed a project manager on the Annual Improvements project [ED due to be released this month] to help implement the mechanism whereby improvements in the standards are identified and amended in an efficient and timely manner. It means that changes to particular standards do not have to wait to become projects on the Board's main agenda.

What did the project involve?

The Improvements process started a year ago. The IASB found it needed additional resource to publish the first ED by October this year. I was tasked with taking the issues that had been suggested for amendment and collating everything agreed by the Board in the 12 months to August and include it in the ED.

My work involved researching suggested amendments and discussing them with other IASB staff, preparing and presenting proposals to the Board, taking their feedback and then writing the section of the ED. Because of the wide-ranging nature of the project, I got a snapshot of the whole standard-setting process, which you probably wouldn't get on short secondments to other projects.

A number of suggestions for amendments were referrals from the IFRIC. The IFRIC had discussed suggestions for interpretations but decided in some cases that an interpretation wasn't the best way to address the issue and that the standard should be amended as part of the Improvements project.

The project is an annual one: an omnibus ED will be published in October every year, itemising all the improvements discussed during the preceding year. There is a three-month comment period (most EDs have four months), as the individual sections of the ED were published on the IASB site after they were discussed by the Board; some will have been on the site for eight or nine months already.

Around 40 different issues in 25 standards have been agreed by the Board in the 2007 ED. The standards affected will become revised standards. Some changes are minor, such as making the wording consistent with other standards (for example, the amendments proposed in IAS 29 are purely to do with terminology, with no change in meaning); other changes are more significant, to address a lack of clarity or an inconsistency within or between standards.

How did your experience in providing advice on technical accounting issues at PwC inform your role at the Board?

This was an excellent project for someone like me whose role at PwC is helping people apply the current standards. The Improvements project was about identifying and addressing difficulties with applying the standards. As project manager at the Board, rather than having to interpret the standards as they are written and applying them to a certain situation, I was able also to consider how the standard could be changed in order to make application easier.

My responsibility was not to recommend to the Board how to change a particular standard to clarify my interpretation of the current literature. It was to recommend changes that would achieve what I believed was more appropriate accounting given the broader context. Some of the changes I have recommended, if approved following the comment period, may require accounting that is different from what I have advised clients in the past. Applying my experience of interpreting the existing standards was really beneficial to my role at the Board.

Is it a case of PwC being the 'practice' and the IASB being the 'theory'?

The IASB has to strike a balance between achieving conceptually robust answers that can be applied in practice. That's the big challenge.

Did you have a 'wish list' of things you wanted to change before you started your secondment?

I had to put aside my own personal desires to see certain things changed. Many areas where I have spent a lot of time giving advice because of difficulties in interpreting the standards were not among those included for amendment in the project.

Did you achieve your personal objectives for taking the secondment?

This project was great in that it allowed me to get to know most of the staff and Board members, because the issues I dealt with covered the spectrum of the standards. It meant I was working with the revenue team, business combinations team, liabilities team, financial instruments team, etc.

What benefits will come from your secondment?

If I have questions or concerns when dealing with the standards in future, I will know who to speak to. Also, I hope in future I will be able to provide input into the development of the standards in an informal way on PwC's behalf, particularly if the staff want additional input on what difficulties exist in practice in applying certain standards. They can not only ask preparers directly, but also approach us for an overview of the issues that we see.

I have also gained some useful insights into working practices, such as understanding what issues that need to be considered as part of the standard-setting process. Knowing how decisions are reached at the Board is valuable; it helps us to influence the debate, to know when it's appropriate to participate, and how best to do that.

How much influence do IASB staff have on the standard-setting process?

Staff are expected to form their own views when researching an issue and developing proposals for the Board. They need to present alternative views, but nevertheless they are expected to conclude which they believe is the most appropriate. This encourages staff to think independently and enables them to take ownership of the issues. The Board then debates those issues and makes the final decision; if it disagrees with the staff, they must re-work the proposals to reflect the Board's view. But I think this makes it a more rewarding experience – I was able to present what I felt was the most appropriate view.

Does this mean the quality of initial proposals varies depending on the person writing it?

The quality should not vary – only people with the right experience and qualifications are employed by the Board. But also there is a quality review process behind the scenes. On a large project, the staff report to a sub-group of board members before they bring their proposals to the Board. This means they can get guidance and it ensures that they understand what the Board wants from them. So there is little risk that they won't develop sound technical arguments and alternatives.

Did anything surprise you about working at the Board?

I was quite surprised that my phone didn't ring! At PwC life is unpredictable. I often get urgent client questions that have to be addressed immediately. No day ever seems to run exactly to plan. But it's quite the opposite at the IASB. It meant I could plan my schedule, how and when to work through the various improvements.

It's very satisfying to plan to do something and then be able to do it when you thought you would. But a lot of the excitement in the job at PwC comes from the unexpected and dealing with live questions, many of which haven't been asked before.

I was also very impressed with the very co-operative approach taken by the staff. I was very aware of this given my need to link in with so many of them. Talking to team leaders and project managers about how my project interacted with theirs led to very open discussions and everyone looking for the best answer.

Are you inspired to work as a Board member?

Yes, but my experience at the Board isn't necessarily a factor in that; it's the belief that trying to achieve one set of global accounting standards is a goal worth working towards. I believe the IASB has a central role in that, and in fact it is a belief they all live under Sir David Tweedie's leadership; to be able to be a part of that would be a great privilege.

Update on Canada's move to IFRS

Canada is six months away from the Accounting Standards Board of Canada's (AcSB) finalisation of its plan to adopt IFRS starting in 2011. Geoff Leverton, a PwC partner and leader of the Global Capital Markets Group in Canada, provides an update.

The Accounting Standards Board in Canada has proposed that Canadian GAAP for public companies migrate to IFRS over the period to 2011. The AcSB's plan to adopt IFRSs in Canada was published in 2006. The exact change-over date has not been established but is set to be finalised in March next year.

The Canadian adoption of IFRS is currently focused on publicly accountable enterprises – companies with publicly traded debt or equity securities or other organisations that are responsible to large or diverse groups of stakeholders. The scope of 'publicly accountable enterprises' is expected to be clarified in the March 2008 announcement.

The AcSB is exploring options related to private businesses, in light of their usually limited accountability. Private companies will be able to adopt IFRS if they choose to. This may be useful to private companies with overseas operations, or Canadian subsidiaries of European parent companies, or companies considering international offerings.

At this point, we do not anticipate changes to the Canadian plan that would delay the 2011 adoption date. In fact, we may find that early adoption is a possibility – and we expect this may be attractive to some. Companies with overseas IFRS reporting obligations, or significant overseas subsidiaries in IFRS-based reporting jurisdictions, would benefit from having the opportunity to move to a single basis of financial reporting on an accelerated timeline. Companies seeking to access overseas capital markets would also benefit from the transparency of reporting under IFRS from the standpoint of comparability and familiarity.

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Over 100 countries have now adopted IFRS, and there are currently a number of others moving in the same direction – including Japan, India, Korea and China – each very significant players in the global economy.

In terms of the actual conversion, we expect that banking, insurance, investment management, oil and gas, utilities and forestry industries will have some of the more challenging conversion issues; however, companies from all industries will need to assess the impacts and take action to convert. While much of Canadian GAAP has been converging with either US GAAP or IFRS over the past decade, there are still differences. Key differences exist in:

- insurance contracts,
- financial instruments,
- full cost versus successful efforts,
- derecognition of financial assets and liabilities,
- consolidation – variable interest entities and special purpose entities,
- stock-based compensation,
- impairment of non-financial assets,
- employee future benefits, and
- income taxes.

Over the summer, developments south of the border have also caught our attention in Canada – namely, the SEC's proposal to eliminate the reconciliation requirement for Foreign Private Issuers. The proposal would eliminate the reconciliation requirement for FPIs that prepare their financial statements in accordance with IFRS. PwC is supportive of the proposal and has encouraged the SEC to consider adoption of the proposed rule in time to allow calendar year-end companies to eliminate the reconciliation for years ending 31 December 2007.
SEC-registered companies in Canada currently have the ability to use full US GAAP financial statements as their primary basis of reporting in Canada. We have had discussions with some of our SEC registrant clients regarding the relative merits of moving to full US GAAP or full IFRS in light of the accommodation available to them in Canada.

Contacts

Canadian companies that view their peer groups as being largely US-based, or that predominantly access the US markets when seeking funding outside of Canada, may be tempted to evaluate the US GAAP route further. Some of the considerations currently impacting this analysis are: clarity around the SEC's acceptance of IFRS without reconciliation; our securities regulators' views on continuing to accept US GAAP as a primary basis of reporting; and guidance from the AcSB on the potential to early adopt IFRS.

Also over the summer, the SEC issued a concept paper discussing the ability of domestic US SEC registrants to prepare their financial statements in accordance with IFRS rather than US GAAP. The elimination of the reconciliation requirement and possibility of domestic US companies moving to US GAAP are encouraging developments in the context of Canada's decision to move to IFRS.

PwC has been developing thought-leadership and speaking at conferences across Canada over the past year to raise awareness of IFRS. We have also been speaking to clients regarding the potential impacts of IFRS on their organisations. We are seeing an increased amount of activity in Canada as companies start to evaluate the impact of moving to IFRS, and we are encouraged by this early activity. Proactively addressing the transition to IFRS will make the change smoother and more manageable over the next four years.

For further help, please contact:

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