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Global EYe on IFRS

Insights on International GAAP®

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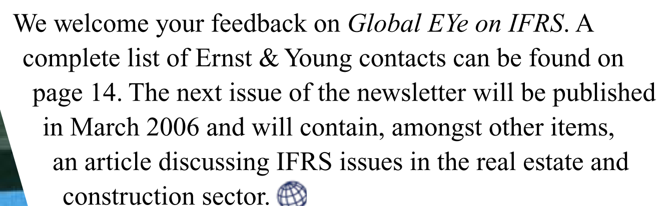
Executive summary

A message from David Lindsell, Ernst & Young's Global Director of IFRS Services

Welcome to the January 2006 issue of *Global EYe on IFRS*. In this twelfth edition of the newsletter we present the following articles:

- The featured article explains Ernst & Young's position on the future agenda of the IASB in relation to fair value accounting. In our opinion, in pursuing its fair value, asset and liability approach to financial reporting, the IASB is giving undue emphasis to what it believes to be 'relevant' information, and insufficient attention to whether the information concerned is reliable and understandable to users of financial statements.
- Our technical focus article addresses the development of the functional currency concept in IAS 21 (as revised in 2003) and the impact of the subsequent amendments to IAS 21 issued by the IASB in December 2005.
- This issue's interview is with Ernst & Young partner Gerd Lützeler. Gerd is the chairperson of the Global IFRS utilities industry group and in his interview he describes the implications of IFRS for that industry.
- The IASB highlights article covers issues discussed during the IASB's December 2005 meeting, including the conceptual framework, insurance contracts, short-term convergence of income taxes, fair value measurement, puttable instruments at fair value, accounting for small and medium-sized entities and joint ventures.

We welcome your feedback on *Global EYe on IFRS*. A complete list of Ernst & Young contacts can be found on page 14. The next issue of the newsletter will be published in March 2006 and will contain, amongst other items, an article discussing IFRS issues in the real estate and construction sector.

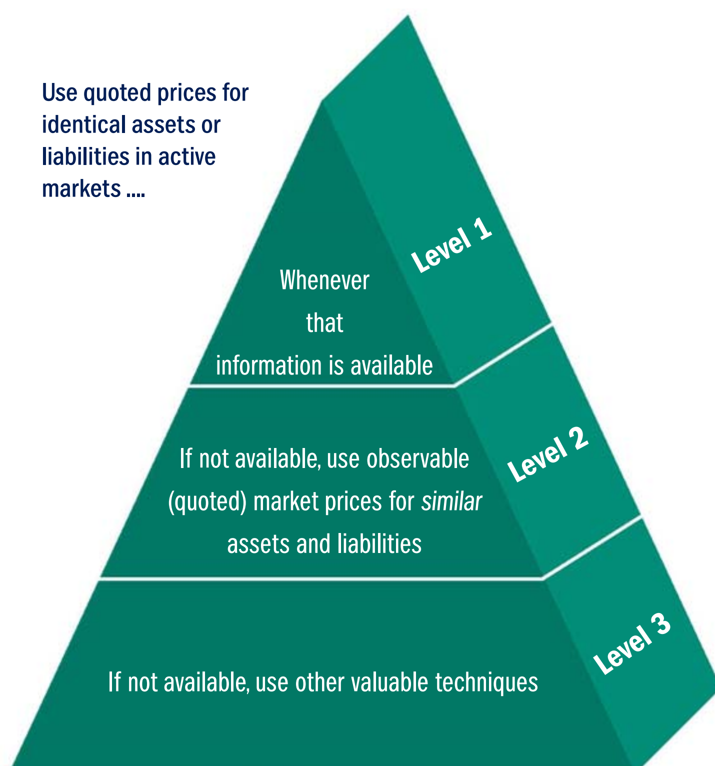


How fair is fair value?

The IASB is intent on introducing 'fair value' as the primary basis for measuring amounts reported in financial statements. Companies are being increasingly required to carry assets and liabilities in the balance sheet at 'fair value' and the fair value definition used by the IASB in its standards is essentially 'market value'. This article summarises Ernst & Young's concerns surrounding whether fair value can be practically applied to assets and liabilities for which there is no contractual market available and what this means for the reliability and objectivity of a set of IFRS accounts in the future.

What does the concept of fair value mean in the context of financial reporting?

The IASB has adopted what is essentially a market value definition of fair value, expressed in most of its standards as "the amount for which an asset could be exchanged, or a liabilities settled, between knowledgeable, willing parties in an arm's length transaction." This market value-based approach is reflected in the 'fair value hierarchy' developed by the US FASB (see below) and embraced by the IASB:



(Derived from: Exposure Draft, Proposed Statement of Financial Accounting Standards, Fair Value Measurements, FASB, June 2004.)

The practical reality is that no 'level 1' or 'level 2' valuation will be available for most assets and liabilities that will be required to be measured at fair value. Fair values will instead be determined by hypothesising what a market price would be if there were a market, very often based on management assumptions about the future and using a valuation model. This will apply, for example, to provisions, pension costs, share-based payments and asset impairments.

The fundamental question is whether the 'level 3' hypothetical fair value of these assets and liabilities is sufficiently understandable, reliable, relevant and comparable to be suitable for financial reporting.

What do we think of fair value?

Ernst & Young believes that, in pursuing its fair value, asset and liability approach to financial reporting, the IASB is giving undue emphasis to what it believes to be 'relevant' information, and insufficient attention to whether the information concerned is reliable and understandable to users of financial statements.

It is generally accepted that the primary objective of financial reporting is to provide relevant, reliable and understandable information to users in order to enable them to make rational economic decisions about the reporting entity. Therefore, users need financial statements that have predictive value in terms of providing a sound basis for decision making, which is a quite different matter from supplying users with financial statements that give the impression that they are themselves predictions. This is at the heart of our concern about fair value determined in accordance with 'level 3' of the standard setters' fair value hierarchy: mathematically modelled fair values based on management predictions are not fair values as that term is generally understood, and their use raises many questions about the reliability and understandability of the information.

We therefore believe that the standard setters now face a significant dilemma: how can they continue to pursue their mark-to-model approach to asset/liability measurement and, at the same time, promulgate accounting standards that will lead to a style of financial reporting that enables investors to evaluate management performance, assess enterprise value and make sound investment decisions?

What is the answer to this conundrum?

A return to the old certainties of historical cost accounting would be a backward step—and we are certainly not advocating that approach. In our view, standard setters should promulgate accounting standards that are capable of being translated into financial reporting practice that provide the financial markets with fully transparent, robust and objective platforms on which future predictions can be based.

The IASB has a responsibility to define clearly the boundaries between fair value information that is sufficiently reliable to be incorporated in the primary statements, and supplementary fair value information to be provided in the notes to the accounts in the form of ranges of possible outcomes and sensitivity analyses.

The path chosen by the IASB means that volatility is introduced into the income statement through the periodic remeasurement of assets and liabilities to fair value. As a consequence, users of financial reports will need clear distinctions to be made between objective and subjective figures, between realised gains and losses, gains and losses based on real market prices and gains and losses based on hypothetical calculations.

Such an explicit approach should ensure that the complexity introduced with the fair value concept and its associated gains and losses does not mislead investors about the true nature of the underlying commercial reality.

Industry-specific IFRS roundtable sessions

In recent months Ernst & Young has hosted a number of industry-specific roundtable sessions on IFRS. These sessions were attended by top executives of major European companies and by Ernst & Young industry and IFRS specialists. Expert speakers stimulated lively discussions on a variety of topics, with a focus on the specific issues that the industries concerned are facing.

While the aim of IFRS is the adoption of a single, transparent and comparable financial language amongst companies, the industry roundtable discussions indicated that it may take a number of years for companies, auditors, regulators and others to become sufficiently familiar with the new accounting language—and to learn from each other—before a reasonable level of consistency is achieved.

The following roundtable sessions were held in 2005:

- *IFRS in the banking industry*: Two roundtable sessions were held in May and October 2005, in Paris and Amsterdam respectively, and were attended by representatives from 25 of Europe's leading banking institutions.
- *IFRS in the gas and oil industry*: Two roundtable sessions were held in December 2005 in Paris and London and were attended by representatives from major gas and oil companies including BP, BG Group, Total and Centrica.
- *IFRS in the building materials industry*: A roundtable session was held in December 2005 in London and was attended by representatives from the major European building materials companies, including CRH, Hanson, Holcim, HeidelbergCement, Italcementi and Tarmac.

Additional roundtables are planned for 2006 including a session for the automotive industry which is scheduled to take place in Geneva, Switzerland in March and a third banking session which is scheduled to take place in London in March.

The implications of IFRS for the utilities industry

Gerd Lützeler
Ernst & Young Germany

This month our interview is with Ernst & Young partner Gerd Lützeler

Based in Düsseldorf, Germany, Gerd has more than 20 years of professional experience. He has worked extensively with major clients in the utilities industry and is a member of both the "Working Party for International Accounting" and the "Committee for International Cooperation" of the Institute of Public Auditors in Germany.

Gerd also chairs Ernst & Young's Global IFRS Utilities Industry Group.

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As many countries move towards IFRS, it is becoming increasingly important for industries to consistently apply the accounting principles of measurement, recognition and disclosure to make comparisons across peer groups possible. *Global EYe on IFRS* recently asked Ernst & Young partner Gerd Lützeler to discuss some of the specific issues facing the utilities industry.

Q. What are the main challenges for the utilities industry as it implements IFRS?

The complex nature of the utilities industry means that companies applying IFRS are particularly affected by the simultaneous introduction of a large number of new standards and the lack of industry-specific guidance on how to apply these standards.

In practice, the utilities industry is probably one of the most affected by the transition to IFRS. For many companies in the utilities industry, the implementation of IFRS has resulted in significant changes in accounting for long-term contracts, fixed assets and emission rights.

With the 2005 half year interim financial statements, we have seen companies report significant gains or losses on energy contracts that now need to be fair valued under IAS 39. Some companies reported fair value gains representing up to 50% of their net income. The difficulty is then to explain to the market the reason for this volatility in earnings. Most of these companies isolate these movements in one way or another in an attempt to separate this impact from the underlying performance of the business. Some presented the changes in fair value of these contracts in a separate column of the income statement, whilst others included disclosures or made comments in the management commentary.

Q.What is the impact of IAS 39 *Financial Instruments: Recognition and Measurement* on the utilities industry, especially in regard to energy contracts?

Most companies in the utilities industry enter into energy contracts. These contracts may be purchase or sale contracts for oil, gas, coal, electricity, etc, and they can be entered into for physical delivery of the commodity, for hedging purposes or for speculative purposes. Generally, under local GAAP, companies used not to fair value the contacts entered into for physical delivery in the course of their normal activity. Because of the complex rules of IAS 39, some of these contracts are now recorded at fair value in the balance sheet with changes in fair value recognised in the income statement. Another impact is the requirement to separate embedded derivatives which are included in executory contracts and recognise them at fair value. The rules for separation and recognition of these derivatives are complex and require significant work within the company to identify and fair value them.

Q. What are the consequences of this increased volatility from an investor relations standpoint?

Firstly, companies need to invest significant time at the senior level to ensure that they understand the implications of the adoption of IAS 39. Senior management needs to be in a position to explain to

the markets why certain amounts recognised in the income statement are not as important as they seem. Companies have to think carefully about how they report performance in their income statement. Fortunately, IFRS allows considerable flexibility in presentation when it comes to reporting performance.

Secondly, companies have sought to mitigate the impact of the standard on earnings volatility by applying hedge accounting under IAS 39. However, the conditions that must be met in order to apply hedge accounting are very strict and it may happen that energy contracts entered into for hedging purposes do not qualify for hedge accounting with the consequence of additional volatility in the income statement. Companies need to make sure that, in these circumstances, communication between the board, shareholders and other stakeholders is effective.

Q. What are the resulting business implications?

One implication is that companies should have better control over the impact of energy trading contracts on their externally reported income when they adapt their commodity risk management processes to the requirements of IAS 39. For example, instead of keeping only one book (as was done by many companies in the past), companies may now need to keep three sets of books for energy contracts: a book for trading activities, a book for hedging activities and an own use (physical) book.

In addition, a number of large players in the industry have invested significant time and resources in improving their internal control around the valuation of complex contracts. Because the figures reported in the income statement are often large and new to management it is sometimes difficult to fully rationalise them. For instance, can management really predict the impact on a long-term gas contract with a complex price formula of a change in the price of Brent by one dollar? Therefore, it is critical that internal controls reduce as much as possible the risk of errors. Companies with a dual listing in the US have led the charge on this issue as a result of the Sarbanes-Oxley Act requirements, but we are seeing more and more companies which are not listed in the US focusing resources on internal controls as well.

Q. IFRIC 3 *Emission Rights* was withdrawn by the IASB. How do you believe European power companies will account for emissions and emission rights under the EU emission trading scheme?

In Europe, different practices are emerging. Some companies are applying the accounting treatment as prescribed by the withdrawn IFRIC 3 interpretation. Ernst & Young believes that this is still an acceptable accounting method as it is an appropriate interpretation of existing IFRS. As an alternative, we believe it is also acceptable for a company to apply a 'net liability method'. Under this method, in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*, a company would record the emission allowances at their nominal amounts (which in this case are nil) and would only recognise a provision to the extent that the actual emissions made could not be settled by allowances on hand.

Q. What are the major issues relating to accounting for fixed assets under IFRS for the utilities industry?

Fixed asset accounting is an important issue for utilities companies as most of them are asset intensive. An issue that is relevant to almost every client in this industry is the application of the components approach. To apply the components approach appropriately, in-depth analysis has to be made to identify the significant components that make up one plant or a grid. These components have to be accounted for separately and need to be depreciated over their own useful life. This will generally be a very challenging task that requires a lot of technical knowledge that cannot be provided by the accounting department on its own.

As in many other industries, companies need to pay particular attention to the determination of their Cash Generating Units (CGUs) for their impairment tests. This is particularly true in the power sector where companies often manage their assets on a portfolio basis. In that case, it needs to be determined whether each individual power station qualifies as a CGU or whether several power stations form one CGU.

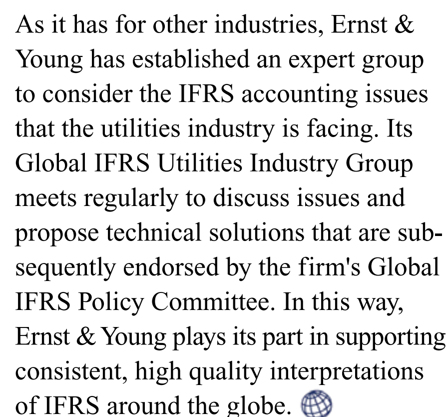
Q. Is the utilities industry itself taking action to ensure that IFRS are consistently applied?

Recognising the many issues that need interpretation, the utilities industry has formed the International Energy Accounting Forum (IEAF). This forum—attended by the large accounting firms and the major utilities companies—discusses key industry-specific issues under IFRS and tries to find common interpretations of these issues and develop best practices. In December 2005, the forum held its seventh meeting.

The forum also wants to be a voice heard by the IASB and the IFRIC to ensure that these bodies consider the impact of their decisions on the industry.

Q. How does Ernst & Young manage the difficult accounting issues that the utilities industry is facing?

As it has for other industries, Ernst & Young has established an expert group to consider the IFRS accounting issues that the utilities industry is facing. Its Global IFRS Utilities Industry Group meets regularly to discuss issues and propose technical solutions that are subsequently endorsed by the firm's Global IFRS Policy Committee. In this way, Ernst & Young plays its part in supporting consistent, high quality interpretations of IFRS around the globe.



Technical focus

Functional currency and the impact of the IASB's recent amendments to IAS 21

Introduction

Functional currency is a concept that was introduced into IAS 21 *The Effects of Changes in Foreign Exchange Rates* when it was revised in 2003, although this is a familiar term in US GAAP, where it has been enshrined in FAS 52 since 1982.

The previous version of IAS 21 used a concept of 'reporting currency'. This was defined as the "reporting currency of an enterprise", but no further clarification was given. SIC-19 *Reporting Currency – Measurement and Presentation of Financial Statements under IAS 21 and IAS 29* addressed this by giving examples of how an entity determines a currency for measuring items in its financial statements (the 'measurement currency').

In revising IAS 21 in 2003, the IASB's main objective was to provide additional guidance on the translation method and on determining the functional and presentation currencies. The most fundamental change was to remove the concept of reporting currency and replace it with two notions:

- functional currency, ie, the currency of the primary economic environment in which the entity operates (incorporating the concept of 'measurement currency' from SIC-19)
- presentation currency, ie, the currency in which financial statements are presented.

The notion of a group functional currency does not exist under IFRS; functional currency is purely an individual entity-/ business operation-based concept.

When a group contains discrete business operations with different functional currencies, the results and financial position of each are expressed in a common currency so that consolidated financial statements may be presented. This common currency is the presentation currency of the group financial statements and is usually, but not necessarily, the functional currency of the ultimate parent company.

IAS 21 requires each individual business operation within a group—be it a subsidiary, joint venture, associate or an entity with foreign operations—to determine its functional currency in accordance with the requirements of the Standard and measure its results and financial position in that currency. The determination of the functional currency takes account of a broad range of factors and not simply the predominant cash flows within the operation. The objective is to identify the currency that has the greatest influence in substance on the operation rather than the currency in which transactions happen to be denominated.

This has resulted in IAS 21 becoming one of the more complex standards both for companies converting to IFRS and for current users adopting the revised standards in 2005. In our experience, many multinational groups have found the process time consuming and challenging, particularly when considering non-trading group entities where the standard's emphasis on external factors suggests that the functional currency of 'corporate' subsidiaries might well be that of the parent, regardless of their country of incorporation or the currency in which their transactions are denominated.

How does management determine functional currency?

IAS 21 defines functional currency as "the currency of the primary economic environment in which the entity operates." Paragraphs 9-11 provide details of the factors to be considered when determining this currency, and these are split into a hierarchy of initial indicators in paragraph 9 and other secondary factors in paragraphs 10 and 11.

For many trading companies, the currency in which the entity primarily generates and expends its cash is the best determinant of this primary economic environment. This is further defined as the currency that influences the sales prices for goods and the cost of sales related to labour and materials, as well as the currency of the country whose competitive forces and regulations mainly determine the sales prices of its goods and services. For an entity that has independent commercial operations, the determination tends to be straightforward based on these factors alone.

However, when the functional currency is not obvious from a consideration of these primary factors, IAS 21 requires management to consider the other factors listed in paragraphs 10 and 11. Paragraph 10 includes factors such as the currency in which funds from financing activities (ie, issuing debt and equity instruments) are generated and the currency in which receipts from operating activities are usually retained. Paragraph 11 requires management to consider the entity's relative independence from other group companies. The criteria include whether a high proportion of the entity's transactions are with another group company, whether the entity in question is able to service its own debt obligations without funds being made available to it by another entity, and whether the cash generated by the entity is readily available for remittance to another group company—the implication being that where a subsidiary is in effect merely an extension of another group entity, for example, the parent, its functional currency is the same as that of the parent.

Notwithstanding this guidance within IAS 21, the determination of functional currency is particularly difficult where the entity in question has few external transactions and acts solely as an intermediate holding company or an investment company within a group structure. In such cases, the determination of the most appropriate functional currency is a matter of management judgement based on the principles set out in the Standard.

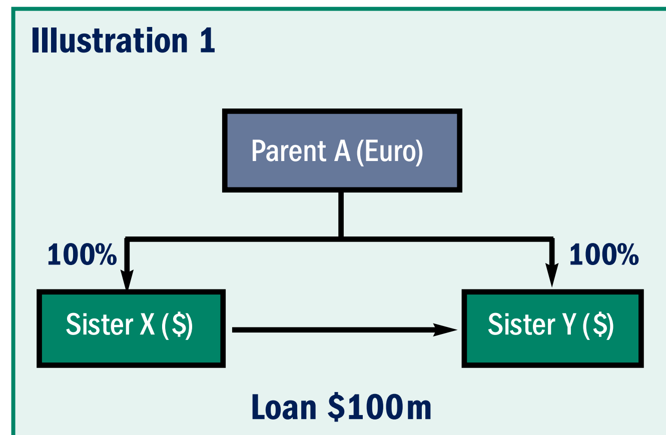
What is the practical impact of the December 2005 amendment to IAS 21?

The 2003 version of IAS 21 was a great improvement on the previous version of IAS 21, bringing clarity to the concepts of functional and presentation currency and incorporating much of the additional guidance from SIC-19. However, some areas of ambiguity and complexity remained, and the IASB decided to address two areas via an amendment to IAS 21 in December 2005.

The amendment changes the wording of IAS 21:

- to clarify that monetary items (receivable or payable) between any subsidiary of the group (which may, itself, be a foreign operation) and a foreign operation may form part of the group's investment in that foreign operation
- to allow monetary items that form part of a reporting entity's net investment in a foreign operation to be denominated in a currency other than the functional currency of either the ultimate parent or the foreign operation itself.

These points are outlined in Illustrations 1 and 2.



Consider the first group structure shown in Illustration 1. Parent A has a functional currency of the euro, which is also the presentation currency of the group (Group A). Parent A has two 100% owned subsidiaries, Sister X and Sister Y, both with a functional currency of the USD. Sister X has excess funds of $100m. It lends the funds to Sister Y with the expectation that the funds will not be returned for some time. The issue is whether a loan needs to be made directly between Parent A and Sister Y to qualify for treatment as a net investment in Sister Y, rather than indirectly through another group company like Sister X.

Ernst & Young's interpretation of IAS 21 was that it is perfectly acceptable for the loan to be made from another group company and that it did not necessarily have to be made by the parent company of the company receiving the loan. However, in order to be permitted to reflect the exchange difference in equity on consolidation, our view was that the loan had to be denominated in the same currency as **either** the ultimate parent **or** the ultimate borrower. So in the scenario shown in Illustration 1, because the loan is denominated in US$, which is the same currency as the functional currency of Sister Y, the transfer of the exchange difference on the loan to equity on consolidation is permitted. However, if the loan had been made in any currency other than €or $, then the exchange difference would have to be recorded in the income statement on consolidation.

Other commentators did not take the same view as Ernst & Young and felt that the Standard could not be interpreted in this manner. The Board has addressed this by adding paragraph 15A to IAS 21 to clarify that the net investment could include a loan between any other entity in the group (eg, Sister X) and the foreign operation. Therefore, in this example, any exchange differences on the loan between Sister X and Sister Y could be reclassified

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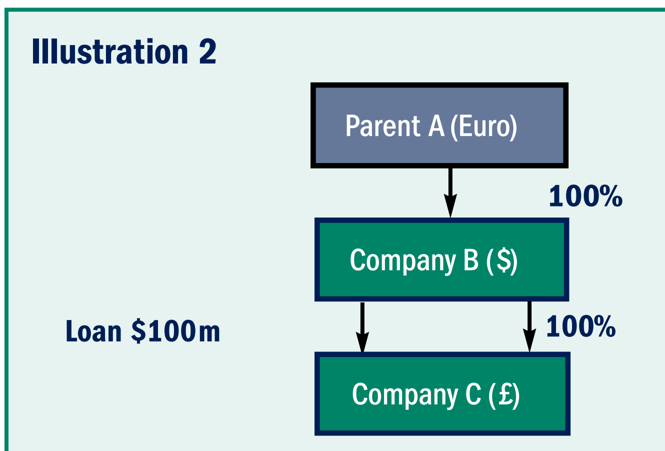
to a separate component of equity in the consolidated accounts of Group A. As a result of our earlier interpretation, we view the addition of paragraph 15A merely as a clarification of the existing position under the Standard and not a change to the requirements of the Standard.

This clarification did not change the fact that the loan had to be made in the same currency as either the functional currency of either the ultimate parent or the ultimate borrower. For this reason, the Board has also amended paragraph 33 of IAS 21 to broaden this requirement. Illustration 2 below demonstrates the impact of this amendment.



Consider the group structure shown in Illustration 2. Parent A has a functional currency of the euro, which is also the presentation currency of the group (Group A). Parent A has a direct investment in an intermediate holding company (Company B) which has a functional currency of the USD. Company B, in turn, has a subsidiary (Company C) which has a functional currency of sterling. Company B lends $100m to Company C. The issue is whether the loan can be accounted for as part of Group A's net investment in Company C and any exchange differences reclassified to equity.

As originally drafted, IAS 21 stated specifically that exchange differences on monetary items that formed part of the reporting entity's net investment in a foreign operation could only be reclassified to equity in the consolidated accounts if the monetary item was denominated in either the functional currency of the ultimate parent or the foreign operation in question. Where the loan was made in a third currency, as shown in Illustration 2, any exchange difference would remain in the income statement of the consolidated accounts of Group A.

The Board has now addressed this issue in the amendment by deleting the parts of paragraph 33 which precluded such exchange differences from being reclassified to equity. This means that the exchange differences on the $100m loan between Company B and Company C can now be reclassified into a separate component of equity in the consolidated financial statements of Group A. This change has allowed many more funding structures to be accounted for as net investments in foreign operations

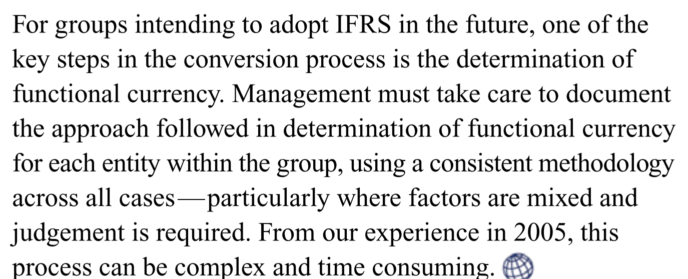
Entities within the European Union who are applying 'IFRS adopted by the EU' can only take advantage of this changed requirement once the amendment to paragraph 33 has formally been adopted by the EU. If the date the financial statements are signed falls before the date of formal adoption, then the entity will have to apply IAS 21 (2003) instead. Formal adoption is expected in the first half of 2006.

If a company applies the paragraph 33 amendment before formal EU adoption, its financial statements may be in compliance with IFRS, but will not be in compliance with IFRS adopted by the EU. Where the effect is material, auditors will be obliged to qualify their audit reports. All other entities that are applying full IFRS (ie, entities not subject to the EU IFRS Regulation or listed EU entities that are reporting under both adopted IFRS and full IFRS) can apply this amendment from 1 January 2006, or earlier if they so desire. However, for the avoidance of doubt, it is Ernst & Young's view that the addition of paragraph 15A is merely a clarification of the existing position under IAS 21 (2003).

What action should be taken in the light of the recent amendments?

All entities should reconsider decisions made in relation to accounting for exchange differences in the consolidated financial statements where the fact pattern is similar to Illustrations 1 and 2. This enables them to determine whether the amendment prompts a change in accounting policy.

Going forward, all entities applying IFRS need to remember that the assessment of functional currency is a key step when considering any change in the group structure or when implementing any new hedging or tax strategies. This will ensure that previous judgements on functional currency made in the group remain valid. Furthermore, should the activities or the fact pattern of a particular entity within the group subsequently change for any reason, the determination of the functional currency of that entity should be reconsidered to identify any changes required.



For groups intending to adopt IFRS in the future, one of the key steps in the conversion process is the determination of functional currency. Management must take care to document the approach followed in determination of functional currency for each entity within the group, using a consistent methodology across all cases—particularly where factors are mixed and judgement is required. From our experience in 2005, this process can be complex and time consuming.

Technical focus

IASB highlights

The IASB (the Board) met in London from 13 to 16 December 2005. The Board discussed the following topics and also spent a portion of the meeting on educational issues.

Conceptual framework

Cost-benefit considerations

The Board continued its discussion on the effect of cost-benefit considerations on the standard setting process. The *Framework for the Preparation and Presentation of Financial Statements* (the Framework) states, "The balance between benefit and cost is a pervasive constraint rather than a qualitative characteristic" of accounting information. There might be differences in how certain qualitative characteristics are applied when cost-benefit constraints are considered in setting standards.

In its earlier meetings the Board decided that the converged Framework should include information about the types of costs that should be considered in deciding what financial information should be provided, as well as criteria to help standard setters decide how to take particular types of costs into account. In addition, the converged Framework will include presumptions about not only the capabilities of financial statement users but also about the responsibilities and capabilities of financial statement preparers and auditors.

The information obtainable from preparers, users and other constituents about their expectations concerning the nature and quantity of benefits and costs is likely to be incomplete. However, in this meeting the Board decided that the Framework should indicate that the standard setters should consider in their deliberations the information that they can obtain. The discussion in the Framework should be expanded.

Definition of financial statement elements

The Board began its discussions of issues relating to the definitions of the elements of financial statements, focusing on the definition of assets. The *present* definition of an asset is "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." The *proposed working definition* of an asset is "a present right, or other access, to an existing economic resource with the ability to generate economic benefits to the entity." The proposed definition defines an asset as a right to an existing economic resource (rather than control of the resource) and does not include the notion of *expected* economic benefits, which is to become a recognition criterion. The definition contains certain ambiguities (eg, what is meant by 'other access') and the Board decided that the staff should refine the proposed working definition.

The reporting entity concept

The Board also began its discussions of issues relating to the concept and definition of a 'reporting entity'. The reporting entity has two aspects: the 'entity' – which relates to boundaries; and the 'reporting' – which relates to external users and the information they require.

On the aspect of 'reporting' the Board decided that the definition of reporting entity should be the same, irrespective of whether the entity has external users who are unable to demand the information they require and therefore must rely on information provided by the entity. For this purpose there would be no difference between, for example, a listed company and a small or medium-sized entity.

The staff will investigate whether a 'reporting entity' concept should be based on a broader concept of control, for example, a concept that might encompass entities under common control.

Insurance contracts: cancellation and renewal options

The Board discussed whether accounting by insurers for insurance contracts should reflect policyholder behaviour if the insurer cannot control that behaviour (eg, in relation to policy cancellation and renewal). The arguments for the recognition and measurement of future renewal premiums depend on the perceived purpose of the financial statements. If the purpose is to show the value of the business then the premiums must be included in some way. If the purpose is to show the worst-case scenario then no renewal premiums would be recognised.

The users and insurers seem to agree that the future premiums are a useful way to assess the value of an insurer's business. The question to focus on is what distinguishes the cash flows that should be included from those that should not.

The Framework defines an asset as "a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity." The application of the Framework appears to prohibit recognition of future premiums unless these premiums are controlled by the insurer. The Board noted that although the insurer does not control the behaviour of policyholders, it

does control its contractual rights. The insurer can exclude other parties from gaining access to the economic benefits that flow from its rights. However, the Board reached no specific conclusions.

Short-term convergence: income taxes

The drafting of amendments to IAS 12 *Income Taxes* and letters from constituents have raised several issues.

The treatment of assets and liabilities that have a tax base that differs from their initial carrying amount

The Board had previously concluded that an asset acquired outside a business combination should be recognised at the fair value it would have if its tax base equalled its fair value. The corresponding deferred tax asset or liability should be recognised as the difference between the fair value of the asset and its tax base, multiplied by the tax rate. The Board decided to extend this principle to the initial recognition of all assets and liabilities that have a tax base that differs from their initial carrying amount, including those acquired within a business combination.

The recognition of deferred tax assets and liabilities arising on the initial recognition of goodwill

IAS 12 provides an exception to the temporary difference approach whereby an entity is prohibited from recognising a deferred tax liability related to goodwill and negative goodwill. The Board decided to require deferred tax liabilities as well as deferred tax assets to be recognised for temporary differences arising on the initial recognition of goodwill.

Fair value measurement

The Board began discussion on the fair value measurement project.

Definition of fair value

The discussion considered the differences between the current definition of fair value in IFRS and the definition of fair value in the FASB's draft Fair Value Measurement standard. The FASB's draft standard defines fair value as "the price that would be received for an asset or paid to transfer a liability in a current transaction between marketplace participants in the reference market for the asset or liability." Although there are differences between the IASB and FASB definitions, the Board decided to adopt the FASB's draft definition.

Puttable instruments at fair value

The Board continued its discussions of the classification under IAS 32 *Financial Instruments: Disclosure and Presentation* of financial instruments puttable at fair value. In our October 2005 issue of *Developments in IFRS for Financial Instruments* (available online at www.ey.com/ifrs) we reported that as a limited quick-fix, the Board decided in September to amend IAS 32 to classify as equity those instruments which represent a 'residual interest' in the entity, which are the most subordinated class of instruments where payments to holders are not limited or guaranteed either before or on liquidation.

Classification of obligations arising on liquidation

The Board decided to propose an amendment to exclude from the definition of a financial liability a contractual obligation that entitles the holder to a pro rata share of the net assets of the entity upon liquidation of the entity.

Shares issued by limited life entities

The Board decided that no amendment is necessary in respect of warrants and other derivatives to be settled by an exchange of a fixed amount of cash for a fixed number of financial instruments issued by a limited life entity.

Issues arising from applying the proposed amendments to a group

The Board discussed the classification of minority interests that are puttable at fair value and concluded that, in the subsidiary's individual financial statements, these types of non-controlling interests might be equity under the proposed amendments if the relevant conditions were satisfied, but that they would not be equity in the group's consolidated financial statements because they are not in the most subordinated class of instruments from the perspective of the group.

Accounting for small and medium-sized entities (SMEs)

The Board continued its consideration of possible recognition and measurement simplifications for SMEs. Among the decisions made by the Board were the following:

- *IAS 16 and IAS 38*: The revaluation options for property, plant and equipment in IAS 16 *Property, Plant and Equipment* and for intangible assets in IAS 38 *Intangible Assets* should be options for SMEs via cross-reference to those standards in the SME standard.

- *IAS 39*: The Board asked the staff to develop an approach that involves classifying financial assets into two categories: those for which there is an observable market price and others.

The Board decided that there is no need for major simplifications in a number of significant areas such as the recognition and measurement of provisions and contingent liabilities, capitalisation of development costs, measurement of share-based payments, purchase method procedure in business combinations, residual values and useful lives of property, plant and equipment, and cash flow statements.

Joint ventures

The Board considered proposals to amend IAS 31 *Interests in Joint Ventures* within the short-term convergence project. It decided that the existing option of proportionate consolidation in IAS 31 should be removed.

The IASB and the IFRIC have recently issued:

- IFRIC Interpretation 7 *Applying the Restatement Approach under IAS 29 Financial Reporting in Hyperinflationary Economies*
- Revised guidance on implementing IFRS 4 *Insurance Contracts*
- IFRIC Interpretation 8 *Scope of IFRS 2*
- IFRIC Draft Interpretation D18 *Interim Financial Reporting and Impairment*

IASB Project Timetable

The following timetable shows Ernst & Young's expectations about the timing of the following projects for the first and second quarters of 2006:

Quarter 1 – 2006

Exposure drafts

- Amendments to IAS 32 *Financial Instruments: Disclosure and Presentation* – Shares Puttable at Fair Value
- Performance reporting – Segment A
- Amendments to IFRS 2 *Share-based Payment* – Vesting conditions and cancellations
- Short-term convergence – IAS 14 *Segment Reporting*
- Short-term convergence – IAS 23 *Borrowing Costs*

Quarter 2 – 2006

Exposure drafts

- Accounting standards for small and medium-sized entities (SMEs)
- Short-term convergence – IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance*
- Short-term convergence – IAS 12 *Income Taxes*
- Fair value measurement

Resources

What's New

Converting to IFRS: An analysis of implementation issues

This publication focuses on specific standards and discusses key implementation issues arising from the adoption of IFRS, illustrated by relevant examples from different industries to help companies, directors, audit committees and readers of financial statements to understand some of the challenges and opportunities of converting from local accounting standards. It includes a section dealing with the impact of conversion to IFRS on a company's organisation, processes and information systems, the modification of which will often be complex and time consuming. You can request a PDF from your local contact (see page 14).

IFRS – The implications for the building materials sector

This publication includes a summary and analysis of the impact of first time adoption of IFRS on the building materials sector and considers how comparable the accounts of existing users and first time adopters will be now that they are all reporting using a single accounting platform. It also includes articles about emission rights, the new IFRS 3 *Business Combinations* standard, and an interview with an industry analyst to get his perspective of IFRS. You can download a copy at ey.com/ifrs.

Coming soon:

IFRS 7 Financial Instruments: Disclosures

This publication provides an overview of IFRS 7 *Financial Instruments: Disclosures* in addition to discussing the main differences compared to the existing disclosure requirements for financial instruments. A comprehensive comparison between IFRS 7 and the existing disclosure requirements in IAS 30 and IAS 32 is presented in the appendix. You will soon be able to download a copy at ey.com/ifrs.

Share-based payments

This publication aims to provide a high level overview of IFRS 2 *Share-based Payment*, in addition to examining whether certain transactions fall within the scope of IFRS 2 and require the Standard to be applied and ultimately recognised by the entity as an expense. This publication also examines at a high level the issues to consider when formulating share-based payment plans. A glossary of specific terms relating to share-based payments has also been included at the end of this document to assist in understanding the topic. You will soon be able to download a copy at ey.com/ifrs.

Developments in IFRS for financial instruments (Issue 18 - January 2006)

This newsletter summarises the main conclusions and Ernst & Young's interpretation of discussions relating to financial instruments at the IASB and the International Financial Reporting Interpretations Committee meetings held in November and December 2005. You will soon be able to download a copy at ey.com/ifrs.

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- IFRS™/US GAAP Comparison – provides a comprehensive financial reporting reference which compares and contrasts the requirements of International GAAP and US GAAP. (1 user subscription – £150.00 or €220 annually)
- International GAAP and GAAS – contains IFRS, International Auditing Standards issued by the IFAC and Ernst & Young commentary, guidance and tools. (1 user subscription – £20.00 or €30 annually)
- International GAAP® Disclosure Checklist 2005 – this electronic checklist shows the disclosure and presentation requirements under IFRS, along with relevant guidance on the scope and interpretation of certain disclosure requirements. Available with any IFRS-related subscription.
- IFRS Web-based Learning – a series of modules that address basic accounting concepts and knowledge of IFRS. The modules may be taken on a self-study basis at any time and in any order; they can also be used as refresher courses. Available with any IFRS-related subscription.

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This comprehensive book from Ernst & Young provides definitive and practical guidance for understanding and interpreting IFRS on a globally consistent basis. You can purchase your copy of the book for £95.00 (€140) from LexisNexis online at www.lexisnexis.co.uk/ifrs or via phone +44 (0) 20 8662 2000 or fax +44 (0) 20 7400 2570.

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- Public Web site
- Ernst & Young's IFRS conversion approach
- Technical publications
- *Global EYe on IFRS* – online version and archived issues
- Ernst & Young global contacts.

Thought Center Webcasts (ey.com/ifrswebcast)

- Interactive discussions that deliver insights on IFRS developments
- Initially delivered live and then archived for on-demand viewing
- IFRS-related webcasts include: IFRS 1 *First-time Adoption of IFRS*, an overview of the IAS 32 and IAS 39 Standards, IFRS 2 *Share-based Payment* and IAS 36 *Impairment of Assets.*

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