

# Global EYE on IFRS

## Insights on International GAAP®

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Executive summary .....	1
Featured article	
Convergence—why rush?.....	2
Interview	
IFRS from an analyst's perspective .....	6
Technical focus	
Managing a mixed accounting model—the challenges faced by the real estate industry in applying IFRS .....	9
IASB highlights .....	13
Resources .....	18
Contacts.....	20

## Executive summary

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

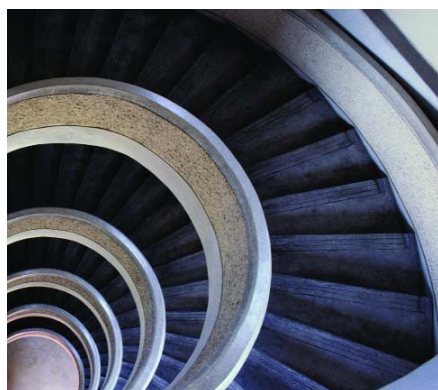
Welcome to the March 2006 Edition of *Global EYE on IFRS*. In this edition of the newsletter we are pleased to present the following:

- The featured article this month is on convergence.
- Our featured interview is with Mike Betts from JPMorgan. Turn to page 6 to find out more about his views on IFRS for the building and construction industry from an analyst's perspective.
- Our technical article examines the challenges of applying a mixed IFRS accounting model in the real estate industry.
- At its February meeting, the IASB discussed, amongst other things, income taxes, short term convergence and phase II of the Business Combinations project. The IASB also continued its discussions on the Exposure Draft of standards for small and medium-sized entities. Turn to page 13 to read about these and other topics in our IASB highlights section. 

We welcome your feedback on *Global EYE on IFRS*. A complete list of contacts can be found on page 20. The May 2006 issue of the newsletter will include an interview with an Ernst & Young partner focusing on IFRS issues in the investment fund industry. It will also examine financial reporting governance.



# Convergence—why rush?



*The IASB reached a stable platform at the end of 2003 with the revision of many IAS (International Accounting Standards) and the issue of several new IFRS standards.*

The objective of this stable platform was to give some certainty to entities required to implement IFRS for the first time in 2005 as they planned their conversion process. The next few months will see some 8,000 European Union entities reach a major milestone in the conversion process as they publish their first full set of accounts under IFRS, as will Australian companies, whose national GAAP was replaced with equivalent IFRS in the same time frame.

However, the benefit of the stable platform is not being felt, nor is the process of conversion complete. IFRS continues to pose many complex issues of interpretation and application, while preparers must now focus on communication to the markets about their financial performance under the new IFRS accounting framework and users now need to absorb the meaning of the changes and evaluate the effects over the longer term. Unfortunately, stability does not appear to be on the IASB's agenda as it stands today.

In October 2002, the US Financial Accounting Standards Board (FASB) and the IASB (jointly referred to as the Boards) agreed to begin the convergence of US GAAP and IFRS—thereby eliminating the differences between the two and creating one set of truly global financial accounting standards. During 2004 and 2005, the two bodies held several joint meetings and started several joint projects—such as business combinations, revenue recognition, performance reporting and the development of a new conceptual framework.

**Table 1: Short-term convergence topics**

To be examined by the FASB	To be examined by the IASB
• Fair value option*	• Borrowing costs
• Impairment (jointly with the IASB)	• Impairment (jointly with the FASB)
• Income tax (jointly with the IASB)	• Income tax (jointly with the FASB)
• Investment properties**	• Government grants
• Research and development	• Joint ventures
• Subsequent events	• Segment reporting
FASB notes: * On the active agenda at 1 July 2005 ** To be considered by the FASB as part of the fair value option project	IASB notes: Topics are part of (or to be added to) the IASB's short-term convergence project, which is already on the agenda

In late February 2006, the momentum of convergence activities was further strengthened when the FASB and the IASB published a joint Memorandum of Understanding (MOU). The intention is that, by 2008, significant steps will have been taken to identify and remove major differences between the standards in some focused areas (so-called 'short-term convergence topics'), and specific progress will have been made in joint projects where both the US GAAP and IFRS accounting practices need improvements. The short-term convergence topics to be addressed are set out in the table to the left. Tables 2 and 3 on page 5 consist of longer-term convergence projects that the Boards plan to address in the future.

Many fear that the IASB's focus on convergence between IFRS and US GAAP will mean constant change over the coming years, instead of being able to look forward to a period of stability and emergence of good practice based on a stable platform. Such concerns were voiced in comment letters to the IASB on business combinations, the first of the major joint projects to have resulted in proposals published simultaneously by both Boards.

The MOU does not, however, reflect the full work programme of the IASB. Along with convergence, work will continue on other accounting areas currently on the agenda and matters arising in the context of IFRS implementation and interpretation. In fact, the IASB's full agenda is extremely wide-ranging. In addition to the IFRS/US GAAP convergence agenda topics, the IASB's work programme includes standards for industries such as insurance and extractive activities, standards for small and medium-sized entities (SMEs) and complex specific issues such as service concessions and emission rights.

Some constituents—including Ernst & Young—consider that the IASB should primarily be concerned with the consistent application of its current standards (assisted by more IFRIC interpretations and by industry guidance) and the development of standards for SMEs, rather than IFRS/US GAAP convergence. Furthermore, some believe that the IASB is setting itself up to fail as a result of over-committing itself.

### **Is convergence a move in the right direction?**

In the press release announcing the MOU, the Boards reaffirmed their belief that creating a single set of global accounting standards will “enhance consistency, comparability and efficiency of financial statements, enabling global markets to move with less friction.” FASB Chairman Robert Hertz has commented that the act of convergence will also facilitate “the quality, comparability and consistency of global financial reporting, enabling the world's capital markets to operate more effectively.”

One reason the convergence programme has been such a strong influence on the IASB is the prospect of the removal of the requirement for a reconciliation between IFRS and US GAAP. Indeed, the MOU states that the objective is to have the IFRS/US GAAP reconciliation requirement removed by 2009.

Although we acknowledge the desirability of this, Ernst & Young does not consider the removal of the IFRS/US GAAP reconciliation requirement to be as important a step as the IASB views it. The number of entities which are required to undertake a US GAAP reconciliation, in comparison to the entities applying IFRS, is minimal, and most of the entities that are subject to the reconciliation requirements are major international companies that can manage the reconciliation task easily.

# Convergence—why rush? (continued)




Furthermore, at least as significant as progress toward convergence to any decision by the SEC to remove the IFRS/US GAAP reconciliation requirement will be the progress made in the next few years in the consistent international application of IFRS.

In our view, the achievement of consistent international application of IFRS is a far more important issue in its own right than convergence with US GAAP, since inconsistency of application has the potential to undermine the credibility of IFRS as, in the words of the International Accounting Standards Committee Foundation's constitution, "a single set of high quality, understandable and enforceable global accounting standards." We therefore believe the need to remove anomalies from, and to develop and issue timely interpretation and guidance on, existing standards should be the IASB's key priority, rather than convergence with US GAAP, and that its work programme should clearly reflect this priority.

Moreover, even if significant progress towards convergence of IFRS and US GAAP can be achieved in the next few years, it is far from clear that the converged standards will be interpreted and applied in the same manner. The IASB is hoping that by basing its standards on coherent, consistent principles, the need for official interpretations will be reduced. This may be the case, but the real question is whether a principles-based approach is possible in the United States where enforcement and litigation are based on the letter (not the spirit) and on accounting rules (not principles). The chairman of the FASB has already concluded that this cannot happen in the current US environment. Furthermore, there are some early indications that some European regulators and standard setters in Europe and elsewhere are determined to issue their own (sometimes questionable) interpretations of IFRS.

## **What will happen in the future?**

While the IASB has a strong focus on convergence, it must act with caution and not alienate preparers and users by pursuing a convergence agenda for the sake of convergence alone. As the majority of entities preparing IFRS financial statements do not also file with the US regulators, there is no justification for making the removal of the IFRS/US GAAP reconciliation requirement the primary objective. The IASB should open up for debate its proposed agenda to ensure that its work programme is prioritised in a way that ensures it meets the principal needs of the majority of preparers and users. 

**Table 2: Topics already on an active agenda**

Convergence topic	Current status on the FASB agenda	Current status on the IASB agenda	Progress expected to be achieved by 2008
1. Business combinations	On agenda – deliberations in process	On agenda – deliberations in process	To have issued converged standards (projected for 2007), the contents and effective dates of which to be determined after taking full account of comments received in response to the Exposure Drafts
2. Consolidations	On agenda – currently inactive	On agenda – no publication yet	To implement work aimed at the completed development of converged standards as a matter of high priority
3. Fair value measurement guidance	Completed standard expected in the first half of 2006	On agenda – deliberations in process	To have issued converged guidance aimed at providing consistency in the application of existing fair value requirements <sup>1</sup>
4. Liabilities and equity distinctions	On agenda – no publication yet	On agenda (will follow the FASB's lead)	To have issued one or more due process documents relating to a proposed standard
5. Performance reporting	On agenda – no publication yet	Exposure draft on a first phase	To have issued one or more due process documents on the full range of topics in this project
6. Post-retirement benefits (including pensions)	On agenda – deliberations underway on the first phase of multi-phase project	Not yet on the agenda	To have issued one or more due process documents relating to a proposed standard
7. Revenue recognition	On agenda – no publication yet	On agenda – no publication yet	To have issued one or more due process documents relating to a proposed comprehensive standard

<sup>1</sup> The fair value guidance measurement project will not extend requirements for the use of fair value measurements, and any proposals regarding increasing the use of fair value accounting will be addressed in the context of the Conceptual Framework and other projects on the FASB's and IASB's respective agendas.

**Table 3: Topics already being researched, but not yet on an active agenda**

Convergence topic	Current status on the FASB agenda	Current status on the IASB agenda	Progress expected to be achieved by 2008
1. Derecognition	Currently in the pre-agenda research phase	On research agenda	To have issued a due process document relating to the results of staff research efforts
2. Financial instruments (replacement of existing standards)	On research agenda and working group established	On research agenda and working group established	To have issued one or more due process documents relating to the accounting for financial instruments
3. Intangible assets	Not yet on agenda	On research agenda (led by a national standard-setter)	To have considered the results of the IASB's research project and made a decision about the scope and timing of a potential agenda project
4. Leases	Pre-agenda research underway	On research agenda (led by a national standard-setter)	To have considered and made a decision about the scope and timing of a potential agenda project

# IFRS from an analyst's perspective



**Mike Betts**  
JPMorgan

## This month our interview is with Mike Betts

Mike joined JPMorgan in January 1999 from Goldman Sachs and he now heads JPMorgan's European Building and Construction team. Previously he worked in funds management at JPMorgan Investment Management as their European construction analyst and for two building contractors—John Laing and Hollandsche Beton Groep.

Mike qualified as a chartered surveyor in 1981 and graduated from Reading University in 1985 with a PhD in construction economics.

One of the intended outcomes of converting to IFRS is that entities will produce more transparent financial statements that will be better understood by analysts who monitor their entity and industry. We recently spoke to Mike Betts, head of JPMorgan's European Building and Construction team, to get his thoughts on IFRS and how this impacts his ability to analyse entities.

### **Q. What do you think of IFRS?**

Given that IFRS should not alter the fundamentals of a business and on the evidence to date, it is tempting to dismiss IFRS as a bit of a non-event. This is probably a mistake, but I cannot honestly say that it has made much difference to me so far. Perhaps my lack of excitement reflects what I am being told. In other words, most CFOs seem to be using their IFRS restatement announcements as a platform to emphasise how little impact IFRS has had—so maybe they are in denial, too.


If anything, the initial impact on me has been negative and I suspect that the different transition options chosen by the first time adopters, and the inevitable teething problems as entities (and their auditors) interpret the new standards slightly differently, could even reduce comparability across the sector—at least in the short term.

On a more positive note, over time, the greater use of fair values, the consistent application of the same standards across Europe (and elsewhere), and the eventual convergence with US GAAP must be beneficial—and getting more things on balance sheet and more disclosures must be a good thing.

### **Q. You have mentioned a negative initial impact. Can you please explain?**

The most obvious example is the one line, post-tax figure for associates and joint ventures that some companies include in pre-tax profits. This makes no sense to me and I really need more detailed disclosures if I am to understand what is going on. I am also worried about financial instruments and the volatility that they are going to introduce. Are we just meant to ignore this or do we penalise companies with active treasury functions because we are worried that, one day, some nasty surprises might emerge?

Financial instruments are a highly complex area and I know that most of us struggle to understand what is going on. Frankly, the current disclosures do not help much and even our own experts in this area find it difficult to work out what is really happening. What I would like is a clear, simple explanation of what an entity is doing with derivatives, and why. I would also welcome some sensitivity analysis so I can work out some of the underlying risks and spot any potential problems. Unless we are careful, the default option will be to be spooked by entities with complex financial instruments; this is something that happened to Cemex a couple of years ago when investors were somewhat unsettled by the use of financial instruments. IFRS may increase the risk of this happening again, even though the imaginative use of instruments to protect against rising energy costs and increasing emission restrictions may be entirely justified.



**Q. What information do you focus on when you look at an annual report?**

Most of it! Of course, I am not interested in platitudes, boiler plate compliance information or pages of detail on directors' remuneration, but my models produce full income statement, balance sheet and cash flow forecasts and I value anything that helps me make better predictions.

In terms of financial indicators, I am keen on EBITDA, free cash flow and interest cover, but the old favourites (earnings and gearing) continue to be very important as well.

When it comes to non-financial indicators, I am very interested in anything that helps me judge sustainability. So, for example, I do look closely at corporate and social responsibility and environmental reporting in the cement entities in order to work out whether or not any cost reduction initiatives might be frustrated by an adverse trend in reported accidents or a poor environmental performance. In aggregates, I am anxious to understand the reserves position in case any significant profit streams are at risk in the short or medium term. I even skim the corporate governance disclosures to judge whether an entity is doing the right things, although I only really use this sort of 'stewardship' information to provide high level assurance that nothing is badly wrong.

Of course, you have to remember that annual reports are not just produced for analysts and, in fact, we have usually seen or heard most of the information before—either in previous announcements or by attending previous presentations. So, in this sense, annual reports are probably more useful to individual, private investors than they are to people like me.

**Q. Do annual reports give you the information that you need to do your job properly?**

Not really. By definition, annual reports give you information about the past and I am only interested in the past if it is a good basis for predicting the future. Often it is not.

Also, the accounts in an annual report provide lots of detailed information on the balance sheet and not enough insights into the profit or loss account. In particular, it is really hard to understand the breakdown of costs incurred and how margins are likely to develop in the future. The key inputs to my models are prices, volumes, and costs, and even though I can normally get a good steer on the first two, I am frequently taken by surprise by cost trends.

In addition, the published cash flows are completely useless. We have to re-work these into a more sensible format, and helpful entities actually do this for us. Sadly, under IFRS, this situation is not going to improve.

As far as non-financial indicators are concerned, it is a mixed report. The cement entities do a great job on environmental reporting and I find the standard method of reporting very helpful. For example, it is relatively easy to work out that one entity has a better accident record than others, and although there are some very good reasons

# IFRS from an analyst's perspective (continued)



why this should be so, it enables me to draw some valuable conclusions. I can also find some useful supplementary information on company websites, such as PowerPoint presentations.


Contrast this with the aggregates entities. Some produce environmental reports consisting primarily of pictures, with few words and even fewer meaningful numbers—and I cannot even find the financial report from others.

I am afraid that the aggregate companies do not do very well on reserves either. Simply telling me the level of total reserves is not much use, even when this is split between consented and unconsented reserves or translated into the number of years of production. This information is at too high a level to be useful. Instead, I would like to see the reserves at each quarry broken down into bands so that, for example, I can work out what percentage of quarries have less than five years to run. The same information about limestone reserves for cement companies would also be useful.

## **Q. So what would you like to see in the future?**

I have probably already mentioned the main points in my earlier answers. As an analyst, I represent the set of people who use annual reports to make investment recommendations and I am conscious that other users have different needs. But, I would like more detailed analysis of the past and more forward looking information. Specifically, more disaggregated income statement and cash flow details in place of endless balance sheet notes to the accounts and, in particular, enough analysis of the type of costs being incurred to enable me to make informed predictions of future margins. Sustainability is becoming increasingly important and more entities should follow the example of the cement companies and agree standard formats for environmental, CSR, and other non-financial reports.

Personally, I am not convinced that IFRS is the answer to my prayers. I understand that a set of IFRS accounts is meant to be more helpful to anyone looking to make investment decisions and the move to fair values is probably what I want. But, not if the measurement techniques are so unreliable that management can deliver any numbers they want and not if the income statement gets cluttered up with significant debits and credits that are difficult to understand and outside management's control.

I also welcome extra disclosures, but not if the accounts become unmanageable because of increased complexity and excessive detail on topics that have no relevance to future performance. From my point of view, annual reports are already too long and, if IFRS is taking us further down the road to US-type details, legalese and repetition, then this would be a retrograde step. Instead, as far as I am concerned, less is more. Entities should separate analysis and commentary on business performance (past and future) from compliance and think hard about who should receive what type of information, and how. In many cases, an entity's website is the quickest, cheapest and most effective distribution channel and I suspect that we will not need too many examples of entities producing annual reports under IFRS of 100-plus pages before we are forced to reconsider the traditional way of reporting to actual and potential stakeholders. 

# Technical focus

## Managing a mixed accounting model—the challenges faced by the real estate industry in applying IFRS



### The need for interpretation

The application of IFRS in the real estate industry raises many questions to which the standards do not provide specific answers and which, therefore, require interpretation. Interpretation is required, for example, in relation to fair value accounting for real estate, leases (including the distinction between finance leases and operating leases, and the treatment of lease incentives and initial direct cost), deferred taxation, dual-nature property and, last but not least, the very extensive disclosure requirements.

A variety of factors have contributed to this enormous need for interpretation: the speed with which IFRS were introduced, the unprecedented scale of the change brought about by IFRS, the dynamic nature of IFRS and their susceptibility to continuous change and the lack of relevant experience of applying IFRS on which preparers and auditors can draw. In addition, the current body of IFRS is a ‘mixed bag’ of standards based on accounting for assets and liabilities measured at cost or fair value (eg, IAS 16 *Property, Plant and Equipment* and IAS 40 *Investment Property*) and standards based on accounting for transactions (eg, IAS 17 *Leases* and IAS 18 *Revenue*). However, especially in relation to the real estate industry, it seems that sometimes the accounting treatment relating to a balance sheet item set out in one standard can be inconsistent with the accounting treatment relating to the recognition of corresponding revenue and expenses set out in another standard.

Industry associations like the European Public Real Estate Association (EPRA) and the Royal Institution of Chartered Surveyors (RICS) have responded to this situation by publishing guidance and recommendations for real estate entities reporting under IFRS; however, so far the scope of this guidance is very limited.

We discuss below just a few of the many issues currently being debated in the industry, setting out what we believe to be acceptable accounting treatments.

### Lessor’s accounting for initial direct costs

Paragraph 52 of IAS 17 requires a lessor to add any initial direct costs incurred in negotiating and arranging an operating lease (such as professional fees) on to the carrying amount of the leased asset. These costs are recognised subsequently as an expense over the lease term, on the same basis as the lease income.

When initial direct costs are added to the carrying amount of a leased investment property measured at fair value, the property’s carrying amount will exceed its fair value. In our view, in such a case the carrying amount of the property needs to be adjusted to fair value with the change (which may correspond to the initial direct costs) being taken to profit or loss.

# Managing a mixed accounting model — the challenges faced by the real estate industry in applying IFRS (continued)



## **Fixed rent increases in operating lease agreements for properties**

In some countries, it is common for property operating lease agreements to provide for fixed rent increases. The reasons for including fixed rent increases in lease agreements may, for example, relate to expected increases in inflation rates or maintenance costs. The question that arises with respect to these fixed increases is whether they should be recognised on a straight-line basis over the entire lease term, or as (and when) they are incurred.

In the *IFRIC Update* of September 2005, the IFRIC concluded, with respect to paragraphs 33 and 50 of IAS 17, that fixed rent increases must generally be recognised on a straight-line basis over the lease term, unless the increases relate to other services that are provided in addition to the rental of the premises. This contrasts with many national accounting principles, under which fixed rent increases were recognised as income or expenditure as incurred. The IFRIC also concluded that the systematic basis referred to in paragraphs 33 and 50 of IAS 17 should not reflect the time value of money. We agree with this conclusion since, otherwise, a straight line basis would never be adopted and because it also does not reflect the “time pattern in which use benefit derived from the leased asset is diminished.” When a fixed rent increase can be shown to relate directly to the increase in other services (such as maintenance costs), it would be acceptable to recognise the income or expenditure on the basis of the period in respect of which it is received or paid.

## **Land use rights**

A land use right is a lease of land. In the December 2005 *IFRIC Update*, the IFRIC provided its view that a lease of land, irrespective of the lease term, is classified as an operating lease unless title is expected to pass to the lessee, or significant risks and rewards associated with ownership of the land at the end of the lease term pass to the lessee (in which case it is considered to be a finance lease). A land use right held by a lessee under an operating lease may be classified and accounted for as investment property if the land use right would otherwise meet the definition of an investment property (ie, it is held to earn rentals and/or for capital appreciation) and the lessee measures the land use right at its fair value with changes in value recognised in profit or loss.

In our view, the accounting treatment for land use rights that are deemed to be operating leases depends on whether the lessee decides to measure the rights using the fair value model under IAS 40 or the cost model:

- When the land use right meets the definition of an investment property and the entity applies the fair value model under IAS 40, the payments made on entering into or acquiring the lease are capitalised as part of the cost of the asset (classified as investment property) and the land use right is subsequently measured at fair value.
- When the entity measures the land use right at cost—either because it does not meet the definition of an investment property, or, when it does, because the entity chooses to apply the cost model— paragraph 14 of IAS 17 sets out that the payments made on entering into or acquiring the land use right ‘represent prepaid lease payments’ and have to be amortised over the lease term in accordance with the pattern of benefits provided (ie, usually on a straight-line basis). In our view, it would, therefore, be appropriate to classify a land use right in such a case as a ‘prepaid lease payment’ (rather than as an ‘intangible asset’ or as an item of ‘property, plant and equipment’, as some argue and has previously been the practice in many countries). However, this is unclear and we are in the process of asking the IFRIC to clarify the position.

### **Revenue recognition on pre-completion contracts for property units**

Developers of residential development projects may conclude sales contracts with customers before construction is completed. The question that arises with respect to these sales contracts is whether revenue is recognised on a completed contract or a percentage of completion or some other basis. As these contracts generally do not meet the definition of construction contracts, revenue recognition has to follow IAS 18 rather than IAS 11. Although IAS 18 does not specifically deal with these kinds of contracts, Example 9 in the Appendix to IAS 18 relates to revenue recognition on real estate sales. However, there are different views as to the practical application of the guidance in Example 9.

It is generally accepted that the completed contract method (ie, revenue is recognised only when the houses or apartments have been constructed, delivered and accepted by the customer) will always be acceptable.

## Managing a mixed accounting model – the challenges faced by the real estate industry in applying IFRS (continued)

However, in our view, in limited circumstances it may also be acceptable for revenue to be recognised by the developer as the development work progresses, provided that all of the following conditions have been met:

- legal title has been transferred or the equitable interest in the property vests in the buyer
- risks and rewards have been transferred to the buyer
- the developer can sue the buyer for specific performance
- neither the developer nor the buyer can withdraw from the contract.

The IFRIC decided in its March 2006 meeting to issue an interpretation that may also include an amendment to or the removal of Example 9 in the Appendix to IAS 18. Such an interpretation may prohibit the recognition of revenue by a developer until the completion of the property. 🌐

### Outlook

Debate over the application of IFRS to real estate transactions and arrangements continues. The 'mixed bag' of relevant standards referred to at the beginning of this article, the lack of experience in applying IFRS and the need for judgement in determining the most appropriate accounting treatment in the particular circumstances all mean that consistency of IFRS interpretation and application will emerge only over time. Even then, differences of view will continue. However, these continuing challenges must be weighed against the immense diversity of accounting practice that has existed until now and the reduction in that diversity which IFRS adoption is already bringing about.



# Technical focus

## IASB highlights



The IASB (the Board) met on 24 and 25 January and from 21 to 24 February 2006. The Board discussed the following topics:

### **Business combinations phase II**

In the light of the disagreement with many aspects of the proposed revised IFRS 3 *Business Combinations* in the 282 comment letters received, the Board discussed a strategy for redeliberating the proposals. The IASB staff expects the re-deliberations to take about a year. If final standards are developed by the IASB and the FASB, it is likely that they would be published in the middle of 2007.

In response to comments on the Exposure Draft (ED), the Board acknowledged the need to improve the definition, so as amongst other things, to clarify that the acquiree must be a business for acquisition accounting to apply and that business combinations include transactions other than typical parent-subsidary purchase transactions, as well as mergers.

The Board reaffirmed its decision to leave the formation of a joint venture outside the scope of the project.

### **Conceptual framework**

Deliberations continued on the joint IASB/FASB Conceptual Framework project (the Framework) with the definitions of asset and liability being discussed. The IASB staff is working towards clarifying the definition of an asset rather than changing the definition as it stands today. However, the Board decided to make a number of changes in the definition of a liability, including the elimination of probability or other notions of likelihood. This change was anticipated in the ED of Amendments to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (see below).

The IASB staff indicated that an ED on the objectives of financial reporting and the qualitative characteristics of decision-useful reporting information was expected in the second quarter of 2006.

### **Amendments to IAS 37 Provisions, Contingent Liabilities and Contingent Assets – Non-financial Liabilities**

In the light of the significant disagreement with the Board's proposals expressed in the 123 comment letters received by the Board, the IASB decided to hold roundtable discussions later in the year. However, the Board also reconfirmed that it intended to press ahead with the effective elimination of the concept of contingent assets and contingent liabilities, analysing them in future in terms of assets and liabilities.

The Board agreed that its re-deliberations will continue until May 2007. Therefore, a standard will not be issued in 2006 as the ED had suggested.

# Technical focus – IASB highlights (continued)

## Revenue recognition

### Revenue recognition methods

The Board discussed two revenue recognition methods. Under the first method (an ‘extinguishment-based’ model), revenue is recognised only when the customer obtains the goods, services or other rights from the entity, at which point the entity has fulfilled its obligation of delivery to the customer criteria. Under the second method (a ‘performance-based’ model), any act of the reporting entity in the production process creates an asset that can be used to satisfy performance obligations under a contract. Accordingly, revenue is recognised as performance occurs. The Board considered examples of contracts under the two methods but reached no conclusions.

### Wholly executory contracts

Following the discussions in the October meeting (see the November 2005 edition of *Global EYe on IFRS*), the Board considered how the allocated customer consideration approach would be applied to wholly executory (or wholly unperformed) revenue contracts. The Board affirmed its previous decision that the unit of account for revenue contracts should be based on the legal remedies for a breach of contract since such remedies provide the basis to determine whether a contract would necessarily result in a separate inflow and outflow of assets for the entity.

For contracts in which the legal remedy for a breach of contract is money damages, the Board decided that the unit of account is the contract as a whole and, under the allocated customer consideration approach being considered by the Board, the net value of the contract as a whole would initially be nil. In the case of such contracts, the Board did not reach a conclusion on whether the unconditional rights and obligations at inception give rise to separate assets and liabilities which are recognised net, or a single asset or liability.

For contracts in which the legal remedy for a breach of contract is specific performance, the Board decided that the unconditional rights and obligations give rise to separate assets and liabilities that are recognised on a gross basis.

## Financial instruments puttable at fair value

In connection with the forthcoming proposed amendments to IAS 32 *Financial Instruments: Presentation*, the Board discussed and agreed on various additional disclosures in financial statements relating to financial instruments puttable at fair value, including their fair value and how this was determined, and the entity’s approach to managing its obligation to repurchase or redeem the instruments.

## Short-term convergence: income tax

The Board discussed the transition arrangements to the amendments to IAS 12 *Income Taxes*. Existing users of IFRS will be required to apply the amendments to the assets and liabilities in the opening balance sheet for the first period beginning after the

effective date of the amended standard and to all events and transactions thereafter. No analysis of cumulative amounts presented in equity or profit or loss would be allowed. Deferred tax would be recognised on assets and liabilities to which the initial recognition exemption currently applies, based on their carrying value and the temporary difference at the balance sheet date, with a corresponding grossing up of the carrying amount of the item concerned.

First-time adopters whose date of transition precedes the publication of the revised standard will be required to apply broadly the same approach, while first time adopters whose date of transition is after the publication of the revised standard will be required to apply the new standard retrospectively.

### **Accounting standards for small and medium-sized entities (SMEs)**

The Board reviewed a preliminary draft of an ED of an IFRS for SMEs. The IASB decided that the IFRS for SMEs should include standards from full IFRS that address common transactions, events or conditions of SMEs. For transactions, events or conditions that are not specifically addressed in the IFRS for SMEs, an SME would be required to look to the requirements and guidance elsewhere in the IFRS for SMEs dealing with similar and related issues. Failing that, the SME should be required to look to the requirements and guidance in IFRS and interpretations of IFRS dealing with similar and related issues.

The Board concluded that the IFRS for SMEs would not include a ‘true and fair override’ similar to that in paragraph 17 of IAS 1 *Presentation of Financial Statements*. However, a question about whether to do so would be included in the invitation to comment on the ED.

The Board believes that full IFRS are appropriate for an entity whose securities are listed, regardless of its size. Responses to the SME discussion paper indicated that some believe that the standards for SMEs would also be appropriate for small listed entities. The Board acknowledged that some jurisdictions could elect to apply IFRS for SMEs to such entities; however, the financial statements would be described as conforming to national GAAP, not to the IFRS for SMEs.

The Board discussed many areas of the proposed ED and agreed on departures from full IFRS in the following cases:

- investments in associates and joint ventures – an SME would be allowed to elect: (a) the cost method with impairment, (b) fair value through profit or loss, (c) the equity method, or in the case of investments in joint ventures, (d) proportionate consolidation. If the cost or fair value method is used, intercompany profits would not be eliminated, but related party disclosures would be required.

# Technical focus – IASB highlights (continued)

## The IASB and the IFRIC have recently issued:

- Exposure Draft – Amendment to IFRS 2 *Share-based Payment: Vesting Conditions and Cancellations*
- Exposure Draft – ED 8 *Operating Segments*
- IASB Discussion paper – *Measurement Bases for Financial Accounting – Measurement on Initial Recognition*
- IFRIC Interpretation 9 *Reassessment of Embedded Derivatives*
- Exposure Draft – Amendment to IAS 1 *Presentation of Financial Statements: A Revised Presentation*

- business combinations – an SME need not separate acquired indefinite-life intangible assets from goodwill, but would separate definite-life intangible assets. An impairment test would only be required if there is an indication of impairment. Guidance would also be included for combined financial statements.

As this indicates, very few exceptions to the recognition and measurement requirements in full IFRS will be available to SMEs.

## Short-term convergence: government grants

In 2004, the Board decided that since IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* is inconsistent with the Framework, the recognition requirements of IAS 20 should be replaced with the recognition requirements for government grants related to assets measured at fair value included in IAS 41 *Agriculture*. However, in its February meeting the Board acknowledged concerns about the conceptual basis of the government grant model in IAS 41, particularly in its treatment of conditional grants, and also noted that its project to amend IAS 37 might yield insights into the appropriate treatment of obligations arising in conditional grants.

Importantly, because the Board had previously concluded that its IAS 20 project would precede its emissions trading project, this deferral also defers the work on the emissions trading project.

## Short-term convergence: borrowing costs

In the November 2005 meeting, the Board decided to eliminate from IAS 23 *Borrowing Costs* the option to immediately expense borrowing costs that are directly attributable to an acquisition, construction or production of a qualifying asset. The Board discussed the transitional arrangements and decided that both first-time adopters and existing IFRS users should apply the proposed amendment prospectively to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is after the effective date, with an option to apply the capitalisation amendments starting at any elected date before the effective date.

## Performance reporting

The Board discussed certain issues identified in drafting the proposed amendments to IAS 1 *Presentation of Financial Statements* and decided that:

- a complete set of financial statements should include a statement of financial position as at the beginning of the comparative period.
- the requirement in IAS 34 *Interim Financial Reporting* to present a complete or condensed statement of financial position as at the beginning and end of the interim period would not change.

## IASB Project Timetable

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

- |   |   |
|---|---|
| ■ Performance reporting – Segment A   | ■ Short-term convergence – IAS 12 <i>Income Taxes</i>             |
| ■ Amendments to IAS 32 <i>Financial Instruments: Disclosures and Presentation</i> – Shares Puttable at Fair Value | ■ Conceptual framework – phase A                                  |
| ■ Short-term convergence – IAS 23 <i>Borrowing Costs</i>  | ■ Fair value measurements   |
|   | ■ Accounting standards for small and medium-sized entities (SMEs) |

- IFRS 1 *First-time Adoption of International Financial Reporting Standards* would be amended to require a first-time adopter to provide, for the latest period in the most recent annual financial statements (ie, the period covered by its final financial statements under previous GAAP), a reconciliation of total recognised income and expense under previous GAAP to its total recognised income and expense under IFRS for the same period.
- since dividends are distributions of equity to owners, dividends will be presented in the statement of changes in equity or in the notes to the financial statements, and not on the face of the statement of recognised income and expense.


### Earnings per share

The Board decided to replace the 'if converted' method currently used in IAS 33 *Earnings per Share* with the 'treasury stock' method for calculating the dilutive effect of convertible instruments as well as options and warrants. Under the 'treasury stock' method, the proceeds receivable on the conversion or exercise of the instruments concerned are assumed to have been used to acquire ordinary shares. For the purpose of the earnings per share calculation those shares are treated as having been issued for no consideration.

### Insurance

The Board continued its discussion on phase II of the insurance contracts project.

- With regard to non-life insurance contracts, the Board had previously decided to pursue both an unearned premium approach (which measures pre-claims liabilities by reference to the unexpired portion of the consideration received) and prospective approaches (that measure pre-claim liabilities by reference to future cash flows). At the February IASB meeting the Board indicated a preference for the prospective, current value-based approaches for the measurement of pre-claim liabilities (using either current entry value or current exit value).
- For life insurance contracts, the Board had previously decided to focus on current value approaches. At the February meeting the Board further reviewed some of the components of these approaches.

The Board plans to continue discussions on the main components of insurance contract accounting models, in addition to agreeing on one of the two prospective approaches for measuring non-life insurance pre-claim liabilities and insurance liabilities for both non-life insurers and life insurers at the March meeting. 

# Resources

## Coming Soon

### ***Developments in IFRS for financial instruments (Issue 19 – March 2006)***

This newsletter summarises the main discussions (and Ernst & Young's interpretation) and conclusions reached concerning financial instruments at the January and February 2006 meetings of the IASB and the March 2006 IFRIC meeting. It also reports on other developments in the reporting of financial instruments under IFRS. You can download a copy at [ey.com/ifrs](http://ey.com/ifrs).



### ***Financial Reporting Governance***

This publication will be the second in our IFRS Stakeholder Series, a series of reports that provide informed points of view on the wider business and economic issues surrounding the development and practical application of IFRS. The report will examine whether it is possible to provide users with financial reports of substantially enhanced usefulness and understandability, at a cost no greater than at present, and of a shorter length. The first paper in this series, *How Fair is Fair Value*, was published in 2005 and is available online at [ey.com/ifrs](http://ey.com/ifrs).



### ***Good Group (International) Limited, International GAAP® Illustrative Interim Financial Statements***

This publication contains the interim financial statements of a fictitious company, Good Group (International) Limited. It incorporates all IFRS in issue as of 31 March 2006. Therefore, it will be useful for entities converting to IFRS and also to existing IFRS users. This publication illustrates how IFRS accounts will be presented in the half year ending 30 June 2006. You can download a copy at [ey.com/ifrs](http://ey.com/ifrs).



### ***IFRS Contingency Plan***

Our updated *IFRS Contingency Plan* will soon be available. This publication will be useful if your entity is behind in its conversion to IFRS. Please contact the appropriate Ernst & Young representative listed on the last page of this newsletter to request a copy.



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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](http://www.lexisnexis.co.uk/ifrs) or via phone +44 (0) 20 8662 2000 or fax +44 (0) 20 7400 2570.

## ey.com/ifrs

- 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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