

IFRS outlook

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Proposed new tax accounting standard – a missed opportunity?

Earlier this year, the IASB issued an Exposure Draft to replace IAS 12 *Income Taxes* which would dramatically change the way income taxes are accounted for. Learn about our key concerns with the proposed changes.

Capitalisation of borrowing costs – distinction between general and specific borrowings

IAS 23 *Borrowing Costs* became effective on 1 January 2009, and entities are now required to capitalise borrowing costs on qualifying assets. In this article, we discuss a practical issue with which many entities are struggling - the distinction between general and specific borrowings.

Resources

Register for our upcoming webcast on *The changing landscape of IFRS*, featuring James S. Turley, Chairman and Chief Executive Officer of Ernst & Young LLP and Ruth Picker, Global Leader of IFRS Services and other experienced professionals. They will look at the increasing pressure from governments and regulators around the world on the IASB to place accounting reform at the top of the agenda.

We welcome your feedback on *IFRS outlook*. Please contact us at ifrs@uk.ey.com. The next issue will be published in October 2009.

Ruth Picker
Global Leader of IFRS Services

Proposed new tax accounting standard – a missed opportunity?



Earlier this year, the International Accounting Standards Board (IASB) issued an Exposure Draft (ED) of a new accounting standard to replace IAS 12 *Income Taxes* which, if adopted, would dramatically impact the way current and deferred taxes and tax uncertainties are defined, measured, presented and disclosed in the financial statements (refer to Box 1 for a listing of proposed changes).

The IASB received over 160 comment letters on the ED, which have been posted on the IASB's website and are now under review. This volume of responses is indicative of a high level of interest in this subject amongst many constituents. The IASB has stated that it would like to issue a new standard on income taxes in the second half of 2010.

The IASB's income taxes project was originally a joint project with the US Financial Accounting Standards Board (FASB), undertaken as part of both Boards' short-term convergence project aimed at eliminating differences between US GAAP and IFRS. However, last year, the FASB suspended its deliberations on the income taxes project.

In this article, we highlight some of the key concerns we expressed in our comment letter to the IASB about the ED.

Refer to Supplement to *IFRS outlook issue 36: ED Income Tax - A proposal to replace IAS 12* for a summary of the main changes proposed by the ED.

We do not believe that the IASB should issue a new standard based on the ED. Instead, there should be some limited, targeted amendments to the current standard, in some cases based on proposals in the ED, reinforced by some additional application and/or implementation guidance.

The two main objectives of the IASB's income taxes project are to clarify and improve IAS 12 and to eliminate differences between US GAAP and IFRS. While we strongly support these objectives, we believe that the ED does not meet them. Furthermore, some areas of the ED are more ambiguous and difficult to interpret, and others less easy to understand conceptually, than the current provisions of IAS 12. We do not think it is reasonable for existing IFRS users to shoulder the burden of implementing a new, and in many respects more complex, standard that does not, in our view, achieve its stated goals.

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Box 1 - Summary of proposed changes

The ED proposes additions or changes to IAS 12 in the following areas:

- ▶ Definitions of ‘tax basis’ and ‘temporary difference’
- ▶ Exceptions to the temporary difference approach (elimination of the initial recognition exception)
- ▶ Measurement of deferred tax liabilities
- ▶ Recognition of deferred tax assets
- ▶ Allocation of tax to components of comprehensive income or equity
- ▶ Balance sheet classification
- ▶ Uncertain tax positions
- ▶ Definitions of tax credit and investment tax credit
- ▶ Other miscellaneous changes
- ▶ Disclosures

Areas for improvement to IAS 12

We acknowledge that accounting for income taxes is a challenging subject and that there is room for improving IAS 12. In fact, in the IASB’s press release issued on publication of the ED, the IASB acknowledged a fundamental review of income tax accounting is being undertaken by a number of national standard-setters working with the IASB. If there is a possibility that the deliberations of those national standard-setters will lead to a major new standard on income taxes being issued in the medium term, we do not believe that it is appropriate to proceed with the issuance of a revised standard on income taxes at this time.

In our experience, several areas of IAS 12 give rise to practical difficulties, in particular:

- ▶ Determining the manner of recovery of assets
- ▶ Some aspects of the initial recognition exception
- ▶ The recognition and measurement of uncertain tax positions
- ▶ The allocation of income taxes within a tax group
- ▶ The treatment of deferred tax assets

We feel that the IASB should retain IAS 12 and focus on complementing it with new or additional guidance in these key areas. In our opinion, that would be more beneficial to IFRS users than completely replacing IAS 12 with the proposals in the ED, with the potential of further changes to income tax accounting after the fundamental review by standard-setters is completed.

We highlight our thoughts on two of the more significant and controversial proposed changes below - those covering uncertain tax positions and definitions of tax base and temporary difference.

Proposed new tax accounting standard – a missed opportunity? *continued*

Uncertain tax positions

Uncertain tax positions arise where there is an uncertainty as to the meaning of the law, the applicability of the law to a particular transaction, or both. IAS 12 does not explicitly address the recognition and measurement of uncertain tax positions, although it notes that the principles of IAS 37 *Provisions, Contingent Assets and Contingent Liabilities* may be relevant to the disclosure of tax-related contingent assets and contingent liabilities. As a result, practice in this area has been varied.

The ED proposes that entities measure uncertain tax positions on an expected outcome basis (i.e., at the probability weighted average of expected outcomes). The ED also proposes that entities should disclose information about the major sources of estimation uncertainties relating to tax effects to enable users to assess the possible financial effects of the estimation uncertainties and their timing (for example, the effects of unresolved disputes with the tax authorities), including:

- ▶ A description of the uncertainty
- ▶ An indication of its possible financial effects on amounts recognised for taxes and the timing of those effects

These proposals, which greatly increase the disclosures required for what are typically sensitive issues, may prove one of the most contentious aspects of the ED. While we support some aspects of the IASB's proposals, we have a number of reservations.

We support the proposed 'probability-weighted average' approach, but only to the extent that it is consistent with the IASB's standard on liabilities expected to be issued later this year. We do not consider that uncertain tax positions should be accounted for differently from other liabilities.

In principle, however, we remain unconvinced by the 'probability-weighted average' approach. Our comment letter in response to the ED of proposed changes to IAS 37 and IAS 19 *Employee Benefits* expressed our view that this approach would not provide relevant information for users, since the measurement of the liability would not be reflective of future cash outflows, as the weighted-average probability on which it is based is merely a subjective estimation.

The ED does not specify the 'unit of account' for uncertain tax positions. In practice, this might be an entire tax computation, individual uncertain positions, or a group of related uncertain positions (e.g., all positions in a particular tax jurisdiction, or all positions of a similar nature or relating to the same interpretation of tax legislation). In our view, the lack of a definition of unit of account creates a number of challenges in the analysis, measurement and disclosure of uncertain tax positions.

We are also concerned that the additional disclosures of uncertain tax positions proposed in the ED could result in excessive and prejudicial disclosure. For this reason, we believe that there should be an exemption equivalent to that already in IAS 37 from disclosure of seriously prejudicial information. It would be anomalous for this exemption to be available only for provisions for liabilities other than income taxes.

Definitions of tax basis and temporary difference

IAS 12 currently requires the tax base of an asset or liability to reflect the manner in which the entity expects to recover the asset (or settle the liability). This effectively makes deferred tax a function of management intent. The IASB is eliminating intent from other areas of financial reporting and therefore proposes to eliminate this concept in IAS 12.

The ED proposes replacing the term 'tax base' with 'tax basis', defined in the ED as 'the measurement, under applicable substantively enacted tax law, of an asset, liability or other item'. The tax basis of an asset (or liability) is determined by the tax consequences of selling (or settling) it for its carrying amount at the reporting date.



At present, a temporary difference is simply the difference between the carrying amount of an item and its tax base. The ED redefines a 'temporary difference' as the difference between the carrying amount of an item and its tax basis that the entity expects will affect taxable profit when the carrying amount of the related asset or liability is recovered or settled (or, in the case of items other than assets or liabilities, will affect taxable profit in the future). In effect, this means that in some cases, the entity's expectations determine the measurement of deferred tax, so the IASB has not been able to remove management intent from the picture entirely.

We do not support the definitions proposed in the ED. Those definitions may result in an entity recording deferred taxes, and an effective tax rate in the income statement, that do not reflect its actual tax position. Under the proposals, the tax basis of an asset or liability is determined on the assumption that the asset or liability is sold or settled at the balance sheet date. However, whether that tax basis gives rise to a temporary difference is to be determined by reference to the actual expected manner of realisation or settlement.

A further source of confusion is whether deferred tax that is required to be calculated on a 'sale' basis is to be strictly regarded as being the tax payable on a sale. This may be relevant to assessing the recoverability of deferred tax assets in jurisdictions where capital and revenue transactions are distinguished for tax purposes. An entity in such a jurisdiction may have brought forward tax losses which can be offset against future revenue profits, but not future capital profits. If a deferred tax liability recognised in the balance sheet is taken to represent the tax payable on a sale (i.e., capital gains tax), it cannot be used as the basis for recognising the deferred tax asset for revenue losses.

Considerations such as these suggest to us that the 'sale basis' approach is neither a holistic model nor appropriate for jurisdictions where assets may (as a matter of tax law, not 'management intent') have more than one tax basis or where there is a distinction between revenue and capital gains for tax purposes. Therefore, we

do not support in principle a presumption that, where there is more than one tax basis, a particular tax basis should always be taken as the starting point for calculating deferred tax. If, however, such a principle is to be adopted, it is surely inappropriate to give preference to the 'sale basis', when in reality nearly all the tax-deductible assets of most entities will be consumed or realised in the course of business rather than sold.

Our overall recommendation is for the approach of IAS 12 to be retained. We agree that there have been differences of view in practice as to how to interpret the phrase 'manner in which the entity expects to recover ... the carrying amount of assets' in IAS 12. However, we believe that these differences would be better addressed by new application or implementation guidance. Such guidance should clarify whether the determination of the manner of recovery must (as we believe) be consistent with assumptions made for the purposes of other IFRS, in particular IAS 16 *Property, Plant and Equipment*, IAS 38 *Intangible Assets* and IAS 36 *Impairment of Assets*, or whether such determination can – or must – be a separate exercise for the purposes of IAS 12.

Conclusion

The ED proposed to replace IAS 12 has been a long-awaited document after several years of analysis by the IASB. We applaud the IASB for taking on the challenge of developing an improved standard for accounting for income taxes. However, we do not feel that the ED issued meets the IASB's objectives to clarify and improve IAS 12 and to eliminate differences between US GAAP and IFRS. We believe that any difficulties in applying the current standard would be better addressed by providing application and/or implementation guidance to the current requirements, rather than by the complete replacement of those requirements by the alternatives proposed in the exposure draft. We will continue to monitor how the IASB responds to the comment letters it received and the next steps in the journey of trying to improve this challenging subject. Given the volume of comment letters, that journey will be closely watched by many.

Capitalisation of borrowing costs – distinction between general and specific borrowings



The basic principle for the capitalisation of borrowing costs is to include those 'borrowing costs that would have been avoided if the expenditure on the qualifying asset had not been made.' Application of this principle is, however, not straightforward and many practical implementation questions arise. In our July issue of *IFRS outlook*, we discussed how foreign currency exchange gains and losses fit within this principle when determining the amount of borrowing costs that are capitalised into qualifying assets in accordance with IAS 23 *Borrowing Costs*. In this article, we consider some of the practical difficulties associated with the distinction between general and specific borrowings, in particular:

- ▶ Identifying specific borrowings
- ▶ Temporary investment of specific borrowings
- ▶ Specific borrowings for non-qualifying assets
- ▶ Change of status of borrowings

Identifying specific borrowings

To the extent that funds have been borrowed specifically for obtaining the qualifying asset, these are easily identifiable as being costs that would otherwise have been avoided. Determining whether the borrowings are specific requires an assessment of the circumstances and evidence supporting the purpose. It is not necessary that the contract with the borrower specifically identifies the purpose of the borrowing, although we would generally expect other internal documentation would exist to support its purpose.

Temporary investment of specific borrowings

Once a borrowing is identified as being specific for the purpose of obtaining a qualifying asset, the actual borrowing costs incurred on that borrowing are capitalised, provided activities to prepare the asset for its intended use are being undertaken. It does not matter how much expenditure actually takes place on the asset.

In many cases, the funds are borrowed in advance of the expenditure on the qualifying asset. Entities will therefore invest the excess funds until they are needed for the purpose for which they were borrowed - that is, to construct the asset. IAS 23 requires that any 'investment income' earned on such temporary investment of specific borrowings is to be deducted from the borrowing costs incurred on those borrowings, such that a 'net' borrowing cost is capitalised. In theory, the investment income offsets part of the cost of borrowings. For this purpose, it does not matter how long the funds are invested.



Example 1

Entity A borrows €1,000,000 on 1 January 2009 for the purpose of constructing a qualifying asset. The entity begins activity on that date and up to 30 June 2009 incurs expenditure on the asset of €200,000. Interest on the loan for this period amounts to €25,000.

On 1 January 2009 Entity A invests €800,000 of the excess funds in cash deposits, earning interest of €16,000 in the period up to 30 June 2009.

The net interest for the period of €9,000 [€25,000 - €16,000] is capitalised as part of the cost of the asset being constructed.

There is no restriction in IAS 23 as to the type of investments in which the funds can be invested. However, we believe that to maintain the conclusion that the funds are specific borrowings, the investment must be of a nature that does not expose the principal amount to the risk of not being recovered. The more risky the investment, the greater is the likelihood that the borrowing is not specific to obtain the qualifying asset. If the investment returns a loss rather than income, such losses are not added to the borrowing costs to be capitalised.

Similarly, if management decides to use the excess funds for other purposes, thereby achieving a saving (avoiding additional costs), imputed interest income cannot be calculated to offset the interest costs incurred. Rather, using the funds in a different manner will be evidence that the borrowings are not specific borrowings.

General borrowings

If no specific borrowings are identified relating to the construction of a qualifying asset, management must identify any general borrowings and determine the amount of related borrowing costs to be capitalised. However, the calculation of the amount of borrowing costs in these instances is not straight forward. Instead of looking at the actual borrowing costs incurred, a capitalisation rate is determined, which is then applied to the actual expenditure incurred on the qualifying asset (although IAS 23 establishes an

'upper limit' of borrowing costs capitalised as the amount of total borrowing costs incurred on general borrowings). However, determining which borrowings qualify to be included in this assessment requires judgment to be applied. Consider example 2 below. Which of the borrowings qualify as general borrowings for determining the applicable capitalisation rate and the limit on the amount of borrowing costs that are eligible to be capitalised?

Example 2

On 1 January 2009 Entity A begins construction of a qualifying asset, which is expected to have a total cost of €3,000,000. Expenditure is incurred during the 12 months ending 31 December 2009 as follows:

On 1 March 2009	€400,000
On 1 July 2009	€600,000
On 1 October 2009	€300,000
Total expenditure	€1,300,000

Entity A enters into a borrowing facility for €1,000,000 on 1 January 2009 for the purposes of constructing this qualifying asset. It draws down the funds as they are needed. The loan is repayable on 31 December 2019. Total borrowing costs on this loan for the 12 months ending 31 December 2009 amount to €45,000.

On 1 March 2009 Entity A enters into a finance lease over another item of PPE (a non-qualifying asset). The lease liability recognised at that date is €600,000. Lease payments are made yearly, and the lease will be fully repaid on 31 March 2011. Interest on the liability is charged at a rate of 3%.

On 1 October 2009 Entity A draws down €500,000 from its overdraft facility, to fund its working capital expenditures. The overdraft has an interest rate of 6%.

Capitalisation of borrowing costs – distinction between general and specific borrowings *continued*

The capitalisation rate is 'the weighted average of the borrowing costs applicable to the borrowings of the entity that are outstanding during the period, other than borrowings made specifically for the purpose of obtaining a qualifying asset.' Therefore, in example 2, the borrowing on 1 January 2009 is specific and all other borrowings (including those specifically entered into to finance a non-qualifying asset) are considered to be general borrowings. The weighted average capitalisation rate is based on the weighted average of borrowings during the period in which the expenditure was funded from general borrowings. In this case, this is for the period October to December, as all previous expenditure was funded from specific borrowings. Therefore the capitalisation rate is 4.4% [$3\% \times (600,000/1,100,000) + 6\% \times (500,000/1,100,000)$]. If the general borrowings are entered into throughout the period that the expenditure incurred is funded from general borrowings, the method of calculating the capitalisation rate can be more complex. Therefore in example 2, if a borrowing was entered into on 1 November, or the overdraft was reduced/repaid between October and December, the calculation is altered to reflect the fact that the borrowings were outstanding for different periods.

This rate is then applied to the expenditure that exceeds the amount of the specific borrowing of €300,000 (€1,300,000 less €1,000,000) based on when the expenditure was incurred, in this case the period 1 October to 31 December 2009. This will result in borrowing costs on general borrowings of €3,300 [$300,000 \times 4.4\% \times 3/12$ (months)]. Total borrowing costs capitalised will therefore be €48,300 [$45,000 + 3,300$].

Some consider that the specific requirement of IAS 23 noted above is contradictory to the general principle of IAS 23 to determine the costs that would otherwise have been avoided. That is, to the extent that a borrowing is specifically incurred for obtaining a non-qualifying asset such as an investment in a controlled business, associate or other item of PPE (including finance lease), the borrowing is not a general borrowing. The IFRIC was also asked to consider this issue and concluded at its July 2009 meeting that judgment was required to be exercised. They also referred to the specific requirements of IAS 23 rather than the general principle, implying that this paragraph took precedence, and therefore there is no basis to exclude the costs from borrowings undertaken specifically for a non-qualifying asset.

Change in the nature of the borrowing

Another question that arises is whether a specific borrowing undertaken to obtain a qualifying asset ever changes its nature into a general borrowing. Consider the following additional factors for example 2 (see example 2A). Is the borrowing entered into on 1 January 2009 now a general borrowing for the purposes of determining the capitalisation rate for the expenditure on the new qualifying asset?

Example 2A

Entity A completes construction of its building on 30 June 2010. On 1 October 2010 Entity A begins to incur expenditure and construction activities on another qualifying asset. No new borrowings are taken out and the construction is funded from working capital. None of the borrowings have yet been repaid (with the exception of the annual rental payment on the finance lease).

Differing views exist as to whether or not borrowings change their nature throughout the period they are outstanding. Some consider that once the asset for which the borrowing was incurred has been completed, and the entity chooses to use its funds on constructing other assets rather than repaying the loan, this changes the nature of the loan into a general borrowing. However, to the extent that the contract linked the repayment of the loan to specific proceeds generated by the entity, its nature as a specific borrowing would be preserved. Others take the view that once the borrowing has been classified as specific, its nature does not change while it remains outstanding. Management will therefore need to exercise judgment in determining its policy and assessing the nature of the loans when construction activity is completed.

Concluding comments

Determining the appropriate borrowing costs to be capitalised into the cost of the construction of a qualifying asset will require significant judgment to be applied, particularly in assessing the nature of the borrowings undertaken. Even once this exercise has been completed, considerable time and effort will be needed to correctly determine the capitalisation rate on general borrowings. This is not an exercise that should be left until the asset has been constructed, or until the end of the reporting period. Having appropriate information systems in place to capture details about each borrowing and its relationship to the expenditure incurred on non-qualifying assets will be critical to determine the correct cost of any constructed asset.

Financial reporting developments

The IASB (the Board) held an additional meeting on 4 August 2009 to discuss proposed amendments to IAS 19 *Employee Benefits*.

Project	Key discussion points	Status
Post employment benefits	The Board discussed the transition requirements for the proposed amendments to the discount rate for post-employment benefit obligations, and made several tentative decisions. Refer to Supplement to <i>IFRS outlook</i> , Issue 56: <i>IASB proposes significant changes to the IAS 19 discount rate</i> .	IFRS on discount rates expected Q4 2009

Q4 2009 = Fourth quarter of 2009,

New documents issued

Project	Comment date
Exposure Draft – <i>Discount Rate for Employee Benefits (proposed amendments to IAS 19)</i>	Open for comment until 30 September 2009
Exposure Draft – <i>Improvements to IFRS</i>	Open for comment until 24 November 2009

Resources

Accounting for investment property under construction (IPUC) – a practical guide

For financial years beginning 1 January 2009, investment property under construction (IPUC) is within the scope of IAS 40 *Investment Property*. For entities selecting to apply the fair value model, valuing IPUC can be a challenge. Accounting for investment property under construction provides practical guidance on valuing IPUC and illustrates the financial statement disclosures.

Supplements to IFRS outlook, Issues 55 – 57

Issue 55: IASB draft discussion paper on extractive activities

Following its decision to defer publication of the Extractive Activities discussion paper until early 2010, the IASB has published a working draft of the discussion paper, which presents the project team's findings and recommendations as a result of their research. This supplement summarises the main findings and recommendations presented in the working draft for the minerals and oil & gas industries.

Issue 56: IASB proposes significant changes to the IAS 19 discount rate

The IASB has proposed changes to the method of determining the discount rate to be used when applying IAS 19 *Employee Benefits*. This supplement summarises the proposed changes and the business implications of the proposals.

Issue 57: Annual improvements 2009 - summary of proposals

The IASB's Improvements Project is an annual project that provides a mechanism for making necessary but non-urgent amendments. This supplement summarises the proposed amendments in the 2009 exposure draft.

Archived webcast

Accounting for rate-regulated activities under IFRS

The IASB recently issued proposals on accounting for the effects of rate regulation. The proposals will impact entities where governmental bodies regulate the prices that can be charged to end users. In this webcast, we explored the scope of the IASB's Exposure Draft and its implications for existing IFRS users and preparers to help CFOs understand the impact the proposals contained in the ED may have on their companies' financial performance.

On 11 August a webcast on this topic was held which looked at how the proposals compared to US GAAP. To listen to this webcast, go to <http://webcast.ey.com/thoughtcenter>



Coming soon

IFRS webcast series

22 and 23 September 2009 - The changing landscape of IFRS

The last twelve months have turned the spotlight on accounting standards and the IASB's activities. The IASB has come under increasing pressure from governments and regulators around the world - particularly in Europe - as many now place accounting reform at the top of the agenda. Much of the debate has focused on the complexity of accounting standards and the use of fair values, and on whether accounting standards 'amplified' the financial crisis or whether they did not go far enough in reporting its effects.

In January 2009, the IASB, together with the US FASB, formed a group to independently consider the implications of the financial crisis on accounting standards. This group - the Financial Crisis Advisory Group (FCAG) - issued its report in July recommending actions for both of the Boards, other policy-makers and the financial statements users.

Join James S. Turley, Chairman and Chief Executive Officer, Ernst & Young LLP, Ruth Picker, Global Leader of IFRS Services, and others as they take a look at the pressures on the IASB's activities, the recommendations of the FCAG, the resulting impact on the IASB's agenda and what this means for the future of IFRS. This webcast is aimed at CEOs, CFOs and audit committee members to help understand the direction that financial reporting is taking now and in the long term.

To register for IFRS webcasts, please go to ey.com/ifrs.

Good Group (International) Limited illustrative financial statements for the year ended 31 December 2009

This publication contains the consolidated financial statements of a fictitious company, Good Group (International) Limited, for the year ending 31 December 2009 based on IFRS in issue at 31 August 2009. The financial statements are cross-referenced to the source literature and include explanatory notes.

Also, look for other industry-based illustrative financial statements soon.

Talking SMEs

With the recently issued *IFRS for Small and Medium-sized Entities* already effective, some entities are considering the issues of transitioning to this standard. This publication discusses the factors an entity should consider in making its decision to transition to this standard.

Negotiation series: step purchase

The first in a series of publications that focuses on issues arising from the new business combinations standard, IFRS 3 *Business Combinations*, that should be considered before finalising a transaction. This publication focuses on step purchases.

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