

In this issue...

New proposals for classifying financial instruments as equity or liability	2
The Fair Value Measurements standard – a project update	5
Financial reporting developments	9
Resources	14

New proposals for classifying financial instruments as equity or liability

The IASB and FASB are working jointly on a new standard on financial instruments with the characteristics of equity that will introduce a number of significant changes from current IFRS requirements. Read about the tentative decisions made by the Boards and the possible impact.

The Fair Value Measurements standard – a project update

The IASB and FASB continued to discuss guidance on fair value measurement with the goal of issuing a converged standard. Learn about the Boards' most recent decisions on this project and the next steps.

Financial reporting developments

Find out more about the IASB's discussion that could significantly impact your business: tentative decisions on financial instruments, fair value measurement, revenue recognition, insurance contracts, consolidation, leases, liabilities, income taxes and annual improvements.

Resources

Register for our upcoming webcast on lessons learned for year-end reporting, which will discuss the challenges faced during the 2009 reporting cycle and the trends that are emerging from the released annual reports.

We welcome your feedback on *IFRS outlook*. Please contact us at ifrs@ey.com.
The next issue will be published in May 2010.

Ruth Picker
Global Leader of IFRS Services

New proposals for classifying financial instruments as equity or liability

In March 2010, the Boards decided to commence drafting an Exposure Draft (ED) on financial instruments with the characteristics of equity. The proposed new standard, to be based on IAS 32 *Financial Instruments: Presentation*, is part of the IASB's joint efforts with the FASB to simplify and improve the accounting for financial instruments.

The International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB), together the 'Boards', are working jointly on a new standard to simplify and improve the reporting for financial instruments with characteristics of equity. Although the scope of the proposed new standard and new 'principles' are unlikely to be dramatically different from current requirements under IFRS, there will be a number of significant changes.

Entities will need to carefully analyse these changes to determine whether the current classification of issued instruments would be affected.

In this article, we describe a few of the expected changes for IFRS reporters, based on the tentative decisions of the Boards and the potential impact. Box 1 summarises the key changes expected to occur that are discussed in this article.

Puttable instruments and instruments issued by entities with specified lives

The new proposals could mean that a greater proportion of puttable instruments and instruments issued by entities with specified lives will be classified as equity.

Puttable instruments, redeemable at the option of the holder, and instruments issued by entities with specified lives, include an obligation for the issuer to redeem the instrument. IAS 32 currently requires entities to classify these instruments as liabilities unless they satisfy certain conditions.

The Boards propose to revise this approach, such that a puttable instrument or an instrument issued by an entity with a specified life will be classified as equity in its entirety if the instrument can only be redeemed:

- ▶ Upon liquidation of the entity
- ▶ When a holder wishes to withdraw, to allow an existing group of shareholders to maintain control of the entity

or

Box 1: Key changes expected

- ▶ There are considerable changes to the accounting of puttable instruments and instruments issued by entities with specified lives, such that a greater proportion of such instruments would be classified as equity
- ▶ For derivatives gross-settled in shares, replacement of the 'fixed-for-fixed condition' with a 'specified-for-specified condition' would mean a greater number of such instruments could be classified as equity
- ▶ As an additional requirement, for a contract to issue shares to be classified as equity, the shares must already be authorised
- ▶ There could be a gain or loss recorded in profit or loss on conversion of convertible debt
- ▶ Transaction costs on the issue of equity instruments would be expensed immediately
- ▶ There are new proposed disclosures for all entities and a supplemental schedule of the fair value of issued equity instruments and long-term debt for public entities

“Entities will need to carefully analyse these changes to determine whether the current classification of issued instruments would be affected.”

- ▶ When a holder, who owns the instrument in order to participate in the activities of the entity, ceases to participate in the activities.

Other puttable instruments, e.g., mutual fund units, would be separated into liability and equity components. The liability component would be similar to a derivative (a written put option) measured at fair value, with the remainder of the transaction price for the puttable instrument allocated to the equity component. If the instrument is redeemable at fair value, the written put option would have minimal value, and the carrying amount of the equity component approximates the transaction price for the instrument.

Furthermore, under IAS 32, certain puttable instruments and instruments issued by specified life entities which impose an obligation on liquidation are classified by a subsidiary as equity, but would be classified as liabilities in the consolidated financial statements of the parent. The Boards propose carrying forward the equity classification in a subsidiary's financial statements through to the consolidated financial statements, such that these instruments would normally retain equity classification on consolidation.

Derivatives with specified-for-specified conditions

The new proposals would result in classification of more derivatives that are gross-settled in shares as equity.

Currently, under IFRS, only gross-settled derivatives that result in the exchange of a fixed number of shares for a fixed price will qualify for equity classification (the 'fixed-for-fixed condition'). This means that the absolute number of shares to be issued must be 'fixed' and the consideration must be fixed in the functional currency of the issuing entity (except for certain rights issued pro rata to all shareholders).

The Boards propose to relax the fixed-for-fixed condition. Derivatives that result in the issue of a specified number of shares for a specified price will qualify for equity classification in their entirety (the 'specified-for-specified condition'). A specified number of shares would include a variable number of shares that represents

a specified percentage of the total shares of the entity outstanding on the issue date. Meanwhile, the price may be specified in the domestic or functional currency of the shareholder where that is different from the currency in which the issuing entity issues equity instruments to domestic shareholders. However, for a multinational corporation with shareholders in various parts of the world that issues derivatives to its shareholders, it is not certain how the 'currency of the shareholder' would be applied and this area of the ED, when issued, will need to be carefully assessed to determine if it is operational.

Settlement in shares

The Boards have decided that an instrument that results in the issue of a specified number of equity shares is only regarded as having an equity component if the entity has sufficient authorised share capital to enable the share issue. If such an instrument is classified as equity, the entity is required to perform an assessment at each reporting date to determine whether there are sufficient authorised shares. If the authorised share capital is less than would be necessary to settle the instrument, the instrument is reclassified as a liability and remains a liability until it is extinguished.

Entities will therefore need to assess the amount of authorised share capital on a regular basis, including before any final standard becomes effective, in order to retain the equity classification.

Accounting for the conversion of convertible debt

The financial results of entities that issue convertible debt could become more volatile.

Bonds that are convertible into a specified number of equity instruments, at the option of the holder, are separated into equity and liability components. Entities do not currently record any profit or loss on conversion of issued convertible debt to shares at the maturity of the debt, and most entities do not record any profit or loss on conversion before maturity. However, this will change with the new standard.

New proposals for classifying financial instruments as equity or liability *continued*

The Boards have decided that shares issued upon conversion of convertible debt should be recognised at their fair value on the issue date. If the convertible debt has been separated into liability and equity components, the difference between the carrying value of the liability component and the fair value of that component (equivalent to the fair value of a similar freestanding debt instrument) on the conversion date will be reported in profit or loss. The difference between the remainder of the fair value of the shares issued (the total fair value of the shares less the fair value of the liability component) and the carrying value of the equity component will be reported directly in equity.

Economic compulsion

Certain instruments may have no settlement requirement, but the issuer may feel compelled to settle, as not doing so would impose significant negative economic consequences. This would be considered an economic compulsion to settle. The Boards have agreed to retain the principle in IAS 32 that economic compulsion is not relevant to the classification of a financial instrument as a liability or equity.

Transaction costs

Entities typically incur transaction costs such as registration, legal, accounting and professional fees when they issue equity instruments. Any incremental transaction costs attributable to the issue are currently accounted for as a deduction from equity. The Boards propose that these costs be expensed immediately.

Disclosures and supplemental schedule

New disclosures are proposed by the Boards. These include information about the nature and terms of instruments within the scope of the new standard, and how the instruments could be settled. Entities will need to carefully evaluate instruments with different terms to ensure that the appropriate disclosures are made.

Furthermore, the Boards have decided that public entities will be required to include a supplemental schedule of capitalisation at fair value. This additional schedule would reconcile the fair value of issued equity instruments and long-term debt at the end of the reporting period to the fair value at the beginning, showing issues, repurchases, expirations and changes in the fair value of the instruments during the period. Determining the fair value of instruments that are less actively traded may be challenging.

Concluding comments

The Boards' proposals to amend IAS 32 will address some of the issues that arise in practice, the result being more instruments are likely to be classified as equity. Entities will, however, need to carefully evaluate the final proposals to determine the financial, legal and regulatory impacts, e.g., the effect on results and financial ratios and compliance with loan covenants and regulatory capital requirements, in addition to understanding the effect on business processes and information systems to implement the proposals.

We encourage entities to respond to the ED when it is issued, with feedback on any practical implementation issues.

An ED is expected by June 2010, with a four-month comment period. The IASB expects to publish a new standard in the first half of 2011.

The Fair Value Measurements standard – a project update

In an effort to improve the definition of the term 'fair value' and how it is measured, the IASB issued an ED in May 2009 on *Fair Value Measurement*. The ED does not propose to change 'when' fair value is used, but rather, focuses on 'how' it is measured. The ED was generally well received, but a predominant theme from commentators was the importance of converging with US GAAP. These concerns led the IASB and the FASB to converge their fair value measurement guidance.

In this article, we explain the tentative decisions reached by the Boards and highlight changes from the ED. These tentative decisions are subject to change.

Refer to Supplement to *IFRS outlook* issue 43: *Fair value measurement – proposals for a new standard* for a summary of the ED and the November 2009 issue of *IFRS outlook* for a summary of our views on the ED.

Scope

One of the objectives of this project is to clarify the definition of 'fair value' and to establish a single source of guidance for measuring it. Therefore, where the term 'fair value' is currently used, or an existing IFRS describes how to measure fair value, and such use or measurement is not in accordance with the proposed guidance, the IASB can either:

- ▶ Retain the term 'fair value' and the related guidance and exempt that IFRS from the scope of this new standard

or

- ▶ Amend that IFRS to use another term that better describes that measurement objective.

Similar to the approach taken in US GAAP, the IASB is taking approach 1 in IFRS 2 *Share-based Payment*, IAS 17 *Leases* and financial liabilities with a demand feature. The IASB is taking approach 2 for reimbursement rights (in IAS 19 *Employee Benefits*), which are measured at the present value of the related obligation.

'Principal market' vs. 'most advantageous market'

A fair value measurement assumes that the sale of the asset or transfer of the liability takes place in a 'market' to which the entity

has access. The Boards decided that the 'principal market' is the reference market when determining fair value (which is consistent with US GAAP) rather than 'most advantageous market' (as proposed in the ED). The principal market for an asset or liability is generally the most advantageous market. There is a rebuttable presumption that the market in which the entity normally transacts is the principal market. However, where these markets differ, the market with the greatest level of activity for the asset or liability to which the entity has 'reasonable access' (i.e., the principal market) is used to estimate fair value.

'Highest and best use' for non-financial assets

The fair value measurement of a non-financial asset considers its highest and best use by market participants, even if this differs from its current (or intended) use by the entity. The ED stated that, in such cases, the fair value of the asset has two components: the value of the asset in its current use; and the 'incremental value' by which the current use differs from the fair value. The Boards decided not to require entities to separate fair value into these components (as proposed in the ED), but retained the requirement for entities to disclose the reasons why such assets are not being employed in their highest and best use.

Valuation premise for non-financial assets

The highest and best use of an asset (maximum value) might be either:

- ▶ In-use: with other assets and liabilities

or

- ▶ In-exchange: on a stand-alone basis.

In response to comments on the ED, the Boards clarified that even when an asset's maximum value is 'in-use', it is assumed that the asset is sold individually.¹ In such cases, it is presumed that market participants have, or can obtain, complimentary assets and liabilities. Complimentary liabilities include 'working capital liabilities' but not 'financing liabilities'. For example, if an entity receives services from a vendor (thereby incurring a working capital liability) to maximise the value of an asset, it is assumed that market participants would also receive those services.

¹ This is not applicable when the 'item' being measured at fair value (based on the applicable unit of account) is an asset group and not an individual asset.

The Fair Value Measurements standard – a project update *continued*

Inactive markets

The Boards agreed that the guidance on markets that are inactive should focus on the situation where there is a significant decline in the volume and level of activity in the market (as opposed to when a market was never active). That is, when assessing whether to consider a transaction in a market when estimating fair value, it is not the level of activity in the market that matters, but rather, whether the transaction is orderly. Accordingly, an entity must consider all observable transaction prices, even if transactions are infrequent, unless there is evidence that the transaction is not orderly or is forced. This is consistent with US GAAP and the ED.

Blockage factors and other premiums and discounts

The Boards distinguished blockage factors from control premiums, marketability and minority interest discounts. They defined a blockage factor as the reduction in the quoted price of a financial instrument that occurs when a market participant sells a large holding of instruments together. As such, a blockage factor is specific to a transaction, not the instrument.

Consistent with the ED, the Boards decided that a fair value measurement excludes blockage factors at any level of the hierarchy. This differs from current US GAAP, which permits including blockage factors for Level 2 and 3 measurements. An amendment changing US GAAP will be exposed by the FASB. The Boards also decided that control premiums, marketability discounts and minority interest discounts are included in Level 2 and 3 measurements, if market participants include those premiums or discounts, **based on the unit of account** for which the relevant IFRS requires fair value measurement. For example, based on the unit of account guidance in IFRS, the Boards noted that an entity might include a control premium when determining the fair value of a cash-generating unit (for impairment tests), investment in a subsidiary, or consideration paid in a business combination. However, including a control premium is generally not appropriate when determining the fair value of an individual financial instrument.

Fair value of a financial instrument

The Boards agreed that the 'highest and best use' concept is only relevant for non-financial assets. Therefore, the concepts of 'in use' and 'in exchange' are not relevant for financial assets or for liabilities.

Guidance developed by the IASB's Expert Advisory Panel² discusses adjustments used when estimating fair value (i.e., when there is no quoted price) and will be included in the final standard. It states that model adjustments, liquidity adjustments, credit risk adjustments and other risk adjustments, are included in a fair value measurement when a market participant makes those adjustments when pricing the asset or liability.

Financial instruments in a portfolio

After much debate, the Boards agreed that entities may:

- ▶ Use mid prices as a basis for establishing fair values for offsetting market risk positions (e.g., interest rate, currency)
- ▶ Apply the price within the bid-ask spread that is most representative of fair value to the net open risk position

However, the 'portfolio approach' will be limited to circumstances when:

- ▶ The entity manages its financial instruments based on the net open risk positions in accordance with its documented risk management strategy, in a consistent manner between periods
- ▶ The market risks that are being offset are substantially the same
- ▶ The financial instruments share common characteristics
- ▶ The financial instruments are measured at fair value on a recurring basis

The Boards also clarified that entities can consider offsetting counterparty credit risk positions when measuring the fair value of financial instruments, when there is a legally enforceable right of offset with the counterparty in the event of default (e.g., a master netting agreement). These concepts are consistent with current practice under IFRS and US GAAP.

² Measuring and disclosing the fair value of financial instruments in markets that are no longer active.



Fair value for 'alternative' investments

US GAAP permits the use of 'net asset value' (NAV) as a practical expedient in measuring the fair value of certain alternative investments (e.g., investments in hedge funds, private equity funds, real estate funds). This practical expedient applies to investments in an 'investment company', without a readily determinable fair value.

To converge with US GAAP, many commentators requested that the IASB grant a similar practical expedient in IFRS. The IASB did not grant this request. Therefore, this will remain a difference between IFRS and US GAAP. The terms 'investment company' and 'NAV' are narrowly defined in US GAAP, but the IASB believes that it is difficult to define these concepts, such that they could be applied consistently internationally.

Day 1 gains and losses

Many commentators on the ED urged for convergence with US GAAP on recognising Day 1 gains and losses:

- ▶ US GAAP – permitted, without a reliability threshold
- ▶ IFRS - prohibited, unless the fair value of the financial instrument is evidenced by comparison with other observable current market transactions in the same instrument, or based on a valuation technique whose variables include only data from observable markets.

While recognising that this issue is important, the IASB believes it is an issue of 'when' and not 'how' to measure fair value. Therefore, this issue will be discussed in the second quarter of 2010, outside of this project.

Table 1: Disclosures

	Measured at fair value on a recurring basis	Measured at fair value on a non-recurring basis, after initial recognition	Not measured at fair value, but fair value is required to be disclosed
Requirements:			
Fair value at the end of the reporting period	✓	✓	✓
Level of the fair value hierarchy	✓	✓	✓
Methods and the inputs used, and changes in the valuation technique, if applicable	✓	✓	
Significant transfers between Level 1 and Level 2 and the reasons therefore	✓		
Reconcile from the opening balances to the closing balances, within Level 3 (including gains and losses, purchases, sales, issues, settlements, and transfers in and out of Level 3)	✓		
Sensitivity analysis for all Level 3 measurements, unless scoped out by another standard	✓		
Examples:	<ul style="list-style-type: none"> ▶ Financial instruments held for trading ▶ Investment properties measured at fair value ▶ Biological assets 	<ul style="list-style-type: none"> ▶ Recoverable amount, for impairment test, when measured using fair value less costs to sell 	<ul style="list-style-type: none"> ▶ Investment properties measured using the cost model

The Fair Value Measurements standard – a project update *continued*

Disclosures

The table on the previous page summarises the minimum disclosure requirements for each class of assets and liabilities (financial and non-financial), which are to be shown in a tabular format, unless another format is more appropriate.

There are additional disclosures required for liabilities measured at fair value after initial recognition.

Other areas

The Boards confirmed most of the other proposals in the ED without significant changes. These are similar to US GAAP and include the following:

- ▶ The definition of 'fair value' and that it is an exit price
- ▶ Circumstances in which transaction price differs from fair value
- ▶ Definition of 'market participant'
- ▶ Measuring the fair value of liabilities (including the effect of non-performance risk and restrictions on transfer).

Business impact

Management should consider whether it has the appropriate expertise, processes and systems to comply with the new standard and plan accordingly. In addition, management should consider the impact on other aspects of its business. For example, if the new standard changes 'how' an entity measures fair value, and therefore, the amount recognised, there may be consequential impact on covenant compliance, remuneration structures, shareholder communications and analyst expectations.

Next steps

The IASB and FASB completed their discussions about the fundamental principles of fair value measurement in April 2010. The IASB will re-expose the proposed requirements for an entity to disclose a sensitivity analysis about Level 3 fair value measurements, given the Boards' tentative decision to require an entity to consider the expected effects of correlation between inputs in that analysis. The FASB plans to issue an exposure draft amending US GAAP during the second quarter of 2010. Thereafter, the Boards plan to issue a converged standard during the third quarter of 2010.

Currently, the ED proposes prospective application and the Boards have not made any decision that would change this proposal. Although not specifically discussed with respect to this project, elsewhere, the IASB has tentatively concluded that the effective date for any projects completed during 2010 would not be before 1 January 2012.

We applaud the Boards for converging on the issue of 'how' to measure fair value. However, without converging on 'when' to measure at fair value (such as for financial instruments), we believe the Boards are only completing half of the task.

Financial reporting developments

The IASB (the Board) met in London on 3 March 2010, 11 March 2010 and again on 15-24 March 2010. Joint meetings were held with the FASB for several sessions during this period. The IFRIC also met on 4-5 March 2010. The table below summarises the main issues discussed at these meetings. In the following pages, you will find more detailed information and insights about the highlighted items in the table.

Projects	Key discussion points	Status
Classification and measurement – financial liabilities	<p>The Board tentatively decided to retain the existing classification and measurement requirements in IAS 39 for financial liabilities, with changes to the recognition of changes in fair value as follows:</p> <ul style="list-style-type: none"> ▶ Financial liabilities designated using the fair value option will be shown at full fair value on the balance sheet, with the full change in fair value recognised in the income statement ▶ The portion of the change in fair value relating to own credit will be transferred from the income statement to OCI (a 'two step' approach) <p>In addition, the Board decided that:</p> <ul style="list-style-type: none"> ▶ Full retrospective application will be required for the proposals on the fair value option ▶ There will be no exemption allowing derivative liabilities on investments in unquoted equity instruments to be recorded at cost, and transition requirements will be the same as those in IFRS 9 <i>Financial Instruments</i> ▶ The subsequent measurement requirements in IAS 39 for loan commitment liabilities and financial guarantee contracts will be carried forward 	ED expected Q2 2010
Derecognition of financial instruments	<p>The Board made tentative decisions on the following topics:</p> <ul style="list-style-type: none"> ▶ Sale and repurchase agreements and similar transactions ▶ Pass-through arrangements and non-recourse loans ▶ Accounting for assets or liabilities of special purpose entities 	ED expected Q2/Q3 2010
Financial instruments with characteristics of equity	<p>The Boards continued their deliberations, and made tentative decisions on a number of topics. See "New proposals for classifying financial instruments as equity or liability" on page 2 for further discussion and insights on this project.</p>	ED expected Q2 2010
Fair value measurement	<p>The Boards continued to work jointly on the key elements of fair value measurement. Their decisions have been discussed in the article on page 5.</p>	IFRS expected in Q3 2010
Revenue recognition	<p>The Boards made tentative decisions on contracts costs and how components of a contract should be accounted.</p>	ED expected Q2 2010
Insurance contracts	<p>The Boards continued deliberating proposals for the ED and made tentative decisions on:</p> <ul style="list-style-type: none"> ▶ Residual margin ▶ Definition of insurance contract ▶ Risk adjustments ▶ Participating features in insurance contracts 	ED expected Q2 2010
Consolidation	<p>The Boards made tentative decisions on the power element of the control definition and control in a principal-agent relationship.</p>	IFRS expected Q4 2010

Financial reporting developments *continued*

Projects	Key discussion points	Status
Financial statement presentation	The Boards made tentative decisions on the transition requirements and effective date and required comparatives.	ED expected Q2 2010
Leases	The Boards continued deliberating proposals for the ED and made tentative decisions on: <ul style="list-style-type: none"> ▶ Measurement at initial recognition ▶ Disclosure requirements for lessees ▶ Lessor accounting 	ED expected Q2 2010
Liabilities – IFRS to replace IAS 37	The Board extended the comment period for the exposure draft <i>Measurement of Liabilities</i> in IAS 37 to 19 May 2010.	IFRS expected Q2 2010
Income taxes	The Board decided that to resolve problems in practice with IAS 12 <i>Income Taxes</i> , the project would be limited to new proposals for: <ul style="list-style-type: none"> ▶ Uncertain tax positions (subject to deliberations on the liabilities project) ▶ Deferred tax on remeasurement of investment property carried at fair value ▶ Other proposals to be made in the ED <i>Income Taxes</i>: <ul style="list-style-type: none"> ▶ Consideration as to whether the recovery of an asset or settlement of liability will affect taxable profit ▶ The recognition of a deferred tax asset in full and an offsetting valuation allowance to the extent necessary, with guidance ▶ Guidance on the meaning of substantive enactment ▶ The allocation of current and deferred taxes within a group that files a consolidated tax return 	ED expected Q3 2010
Joint arrangements	The Board made tentative decisions on transitional provisions and disclosures.	IFRS expected Q2 2010
Annual improvements	The Board accepted IFRIC's proposals, as discussed in our <i>IFRS outlook</i> February 2010, with an additional amendment to IFRS 1, as follows: <ul style="list-style-type: none"> ▶ Extend the 'deemed cost' exemption to event-driven revaluations beyond events that took place within the first annual period after the amendment becomes effective, thereby including entities who had adopted IFRS before IFRS 1 was issued. 	Amendments expected in April 2010
IFRIC tentative agenda decisions	The IFRIC tentatively decided not to add the following issues to its agenda: <ul style="list-style-type: none"> ▶ IFRS 1 <i>First-time Adoption of International Financial Reporting Standards</i> – Accounting for costs included in self-constructed assets on transition ▶ IFRS 5 <i>Non-current Assets Held for Sale and Discontinued Operations</i> – Reversal of disposal group impairment losses relating to goodwill ▶ IAS 26 <i>Accounting and Reporting by Retirees Benefit Plans</i> – Valuation of plan assets 	The IFRIC will confirm its tentative decisions at its May 2010 meeting
Stripping costs	The IFRIC continued discussing the accounting for stripping costs incurred during production and tentatively decided that: <ul style="list-style-type: none"> ▶ The costs of waste removal and the associated benefit represent an asset to the entity which should be allocated to current and future periods using the specific identification approach ▶ The unit of account would be the stripping campaign 	Draft interpretation expected in H2 2010

ED = Exposure Draft, Q2 2010 = Second quarter of 2010, Q3 2010 = Third quarter of 2010, Q4 2010 = Fourth quarter of 2010, H2 2010 = Second half of 2010



IFRIC – Items not taken onto the IFRIC's agenda

The IFRIC confirmed the following tentative decisions made at its March 2010 meeting with no significant changes from the tentative decisions discussed in the *IFRS outlook* February 2010 edition:

- ▶ IAS 21 *The Effects of Changes in Foreign Exchange Rates – Determination of functional currency of an investment holding company*
- ▶ IAS 32 *Financial Instruments: Presentation – Shareholder discretion*
- ▶ IAS 36 *Impairment of Assets – Interaction with transition requirements of IFRS 8*
- ▶ IAS 39 *Financial Instruments: Recognition and Measurement – Unit of account for forward contracts with volumetric optionality*

Derecognition of financial instruments

In previous meetings, the Board decided to further develop the alternative approach ('new approach') proposed in the original ED on derecognition of financial assets (March 2009). The underlying principle of the new approach is that a financial asset is derecognised when the transferor does not have present access for its own benefit to all of the cash flows or other economic benefits of the transferred asset.

This month, the Board continued to develop this new approach, and reached the following tentative decisions:

Sale and repurchase agreements and similar transactions

The sale of a financial asset that is accompanied by an agreement to repurchase the same, or substantially the same, asset before maturity would be accounted for as a secured borrowing.

For a financial asset to meet the 'substantially the same asset' requirement, it must have:

- ▶ The same primary obligor, maturity and aggregate unpaid principal amount or principal amounts within accepted 'good delivery' standards for the type of security involved.
- ▶ Identical contractual interest rates, form and type so as to provide the same risks and rights.
- ▶ Similar assets as collateral.

Pass-through arrangements and non-recourse loans

The new approach will not include the criteria currently in IAS 39 for pass-through arrangements as the new approach specifically addresses issues with such arrangements.

For those non-recourse loans which are effectively pass-through arrangements (i.e., the primary means from which the borrower is expected to repay the principal and interest due on the loan are the cash inflows from the secured asset), the borrower would not

recognise the secured asset subject to the pass-through arrangement nor would it recognise a liability. The lender would recognise the secured asset, and would not recognise a loan receivable.

Accounting for assets or liabilities of special purpose entities (SPE)

If the beneficial interests issued by a SPE gives the holder the ability to obtain and restrict others access to the economic benefits of the specific assets or the portfolio of assets in the SPE, those assets will be derecognised by the SPE under the new approach.

The same derecognition principle cannot be applied to a financial instrument that can either be an asset or liability over its life (for example an interest rate swap), or a financial liability, unless the counterparty to the financial liability has expressly consented to its novation. Hence, the application of the new approach will not necessarily result in SPEs becoming 'empty shells' if they have entered into hedging derivatives, as it will be necessary to apply the derecognition principles to the combined portfolio of assets and derivatives. Only if the derivatives satisfy the liability derecognition requirements can the combined portfolio be derecognised.

Revenue recognition

The Boards tentatively decided that an entity should recognise the following costs as expenses when incurred:

- ▶ The costs of obtaining a contract
- ▶ Costs that relate to satisfied performance obligations in the contract
- ▶ Abnormal amounts of wasted labour, material or other fulfilment costs

If the costs incurred in fulfilling a contract are not eligible for capitalisation in accordance with other standards, an entity would still recognise an asset if the costs generate or enhance an asset the entity will use to satisfy performance obligations in a contract and are probable of recovery. In such cases, the contract costs would be capitalised as an asset and amortised as the goods or services to which the asset relates are transferred to the customer. The asset will be subject to impairment.

Insurance contracts

The Boards reached the following tentative decisions:

Residual margin

- ▶ An insurer should release the residual margin over the period of cover based on the passage of time, or on the expected benefits and claims that best reflects the exposure from providing insurance coverage, if this differs significantly from the passage of time.

Financial reporting developments *continued*

- ▶ Initial measurement of the residual margin would exclude an amount equal to the incremental acquisition costs for the insurance contract.

Definition of insurance contract

- ▶ The current definition of an insurance contract in IFRS 4 *Insurance Contracts* and the related guidance in Appendix B of IFRS 4 will be used in the upcoming exposure draft.
- ▶ The factors to consider in evaluating the significance of insurance risk would change from absolute amounts to present values.
- ▶ To amend the guidance in IFRS 4 to explain that contractual terms that delay timely reimbursement to the policyholder can significantly reduce insurance risk. Hence, some contracts may not meet the definition of an insurance contract.

Risk adjustments and participating features in insurance contracts

The IASB tentatively decided that a separate risk adjustment would be made when measuring the liability so that it reflects the amount an insurer would rationally pay to be relieved of it. This is consistent with recent proposals to measure other non-financial liabilities. It also decided that payments arising from a participating feature would be included in the measurement of insurance contracts in the same way as any other contractual cash flows. Both these decisions differ from the tentative decisions of the FASB.

Consolidation

The Boards tentatively decided that the power element of the control definition would be met by a reporting entity if it has the power to direct the activities that significantly affect the returns generated. This would be demonstrated by:

- ▶ The contractual ability to direct the activities of the entity via either the voting rights, contractual rights or a combination of both
- ▶ Its ability to direct the activities of the entity notwithstanding the rights held by other parties
- ▶ Other non-contractual indicators of power that provide evidence of the reporting entity's ability to direct the activities of the entity

The Boards tentatively decided that when assessing control in a principal-agency relationship, the overall relationship between the decision-maker, the entity being managed and other interest holder need to be considered. Factors to consider include the scope of decision-making authority, rights held by other parties, remuneration of the decision-maker and the decision-maker's exposure to variability of returns.

Financial statement presentation

The Boards made the following tentative decisions:

- ▶ Full retrospective application of the proposed changes will be

required which would entail, for each prior period, reclassifications, new groupings and disaggregation of comparative information presented and disclosed, as if the new presentation provisions had always been applied. However, the Boards plan to collectively consider the effective dates and transition for standards that are to be completed by 30 June 2011, therefore this may change.

- ▶ To clarify that only one comparative period is required for a complete set of financial statements, although this would not preclude additional comparative periods from being presented as long as they were consistent with IFRS and presented with the same prominence as the required financial statements .
- ▶ When there is a change in accounting policy, restatement or reclassification, an opening statement of financial position for that one comparative period is the only additional statement that an entity needs to present.
- ▶ If an item of other comprehensive income relates to, or will relate to, a discontinued operation, it will be separately presented as such in the statement of comprehensive income.

Leases

The Boards reached the following tentative decisions:

Measurement at initial recognition

- ▶ Initial measurement of assets and liabilities arising from lease contracts will be determined at the inception of the lease.

Disclosure requirements for lessees

- ▶ The disclosure requirements include qualitative and quantitative disclosures about the lease contracts recognised, the assumptions used, estimates made and uncertainty in cash flows. A reconciliation between the opening and closing balances of right-of-use assets and obligations to pay rentals would also be required.

Lessor accounting

- ▶ The leased asset, receivable and performance obligation would be separately presented in the statement of financial position. In the statement of cash flows, repayments of the lease receivable and related interest income would be classified as operating activities. Interest income, lease income and depreciation expense, would also be presented separately in the statement of comprehensive income.
- ▶ The residual value guarantee will be measured using an expected outcome technique and recognised as part of the lease receivable.
- ▶ The residual value guarantee and consequently the carrying amount of the receivable will be reassessed at each reporting date.



- ▶ Changes in the residual value guarantees furnished by a lessee would be treated as an adjustment to the lessor's receivable and performance obligation. Unrelated third-party residual value would be accounted for in accordance with the accounting for other guarantees.
- ▶ Lessors would recognise and measure all outstanding lease payments as of the date of initial application and discount this based on the original rate charged by the lessor to the lessee.
- ▶ Previously derecognised leased assets would be reinstated at depreciated cost, adjusted for impairment and revaluation.
- ▶ To further develop and to seek public feedback on the 'derecognition' accounting model for lessors as an alternative to the performance obligation model.

Joint arrangements

The Board tentatively decided that jointly controlled entities will transition from proportionate consolidation to the equity method by aggregating the carrying values of the proportionate consolidated assets and liabilities into a single line item. This net asset will be tested for impairment for all periods presented in the financial statements.

It also tentatively decided to align the disclosure objectives for joint arrangements and associates. Therefore, regardless of whether equity accounting is applied or the investment is carried at fair value (by a venture capital entity), summarised financial information would be presented for all joint ventures and associates.

IFRIC - Items not taken onto the IFRIC's agenda (tentative decisions)

IFRS 1 *First-time Adoption of International Financial Reporting Standards* – Accounting for costs included in self-constructed assets on transition

The IFRIC was asked to provide guidance on how an entity which previously capitalised certain costs, including actuarial gains and losses, as part of self-constructed assets, in accordance with its previous GAAP accounting policies should account for the carrying value of such assets on transition to IFRS. As the entity had changed its accounting policy for actuarial gains and losses and determined that they should no longer be capitalised, the query was whether the entity should adjust the carrying amount of self-constructed assets on transition to IFRSs and, if not, how the change in its actuarial gains and losses accounting policy should be reflected in the carrying amount of self-constructed assets in subsequent reporting periods.

The IFRIC noted that IFRS 1 provides guidance that accounting policies are to be applied consistently for all period presented in its

first IFRS financial statements. As the issue has only limited impact on certain entities in jurisdictions transitioning to IFRS and there were no significantly divergent interpretations (either emerging or already existing in practice), the IFRIC decided not to add this issue to its agenda.

IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* – Reversal of disposal group impairment losses relating to goodwill

The IFRIC received a request for guidance on whether an impairment loss for a disposal group classified as held for sale can be reversed if it related to goodwill. Whilst the IFRIC noted a potential conflict between the guidance in paragraph 22 and paragraph 23 of IFRS 5 relating to the recognition and allocation of the reversal of an impairment loss for a disposal group when it relates to goodwill, this was not an issue that could be resolved in a timely manner within the confines of existing IFRSs and the *Framework*. Coupled with the Board's decision not to add a project to its agenda to address IFRS 5 impairment measurement and reversal issues at this time, the IFRIC recommended that the Board address this issue in a post-implementation review of IFRS 5.

IAS 26 *Accounting and Reporting by Retirement Benefit Plans* – Valuation of plan assets

The IFRIC was asked to clarify the interaction between IAS 26 and IAS 39 *Financial Instruments: Recognition and Measurement* relating to the accounting for retirement benefit plan investments (plan assets), by retirement benefit plans. The IFRIC noted that there was guidance in IAS 26 for plan assets to be carried at fair value and that that changes in the fair value of plan assets should be presented and disclosed in the statement of changes in net assets available for benefits. Hence, the IFRIC decided not to add this issue to its agenda or to recommend an amendment to the standards.

New documents issued

Project	Comment period
Conceptual Framework for Financial Reporting: The Reporting Entity	Open for comment until 15 July 2010

Change of name

The International Financial Reporting Interpretations Committee (IFRIC) changed its name to IFRS Interpretations Committee (Interpretations Committee) on 31 March 2010. The Standards Advisory Council (SAC) changed its name to IFRS Advisory Council (Advisory Council) on the same date.

Resources

Supplement to *IFRS outlook*

Issue 68: Proposals to describe the reporting entity

The IASB and the US FASB recently issued an Exposure Draft entitled *Conceptual Framework for Financial Reporting: the Reporting Entity* with proposals for the description of a reporting entity. This proposal is welcome given the current lack of a definition of a reporting entity and is expected to be useful to preparers, regulators and auditors. Our supplement summarises the proposed description of a reporting entity included in the ED, which includes a discussion of what the proposals mean for consolidated financial statements, combined financial statements and parent-only financial statements.

Insurance Accounting Alert March 2010

In March, the Boards discussed insurance contracts at a number of meetings. The Boards were seeking to resolve a number of open issues including the definition of insurance, measurement of the risk adjustment, acquisition costs and the residual margin in order to meet their timetable for issuing an Exposure Draft of a new standard. Our newsletter contains a summary of the various agenda papers for the meetings.

Archived webcast

23 March 2010 – Financial instruments – further insights

Following the completion of the first phase of the project to replace IAS 39 *Financial Instruments: Recognition and Measurement*, our panel discussed the ongoing proposals to reform the accounting for financial instruments and their potential impacts for businesses. The panel also offered insights on the key application issues in adopting the amendments to IFRS 7 for the year ending 31 December 2009. This webcast is intended to assist CFOs in understanding the significant practical challenges and the full impact on their reporting performance.

Coming soon

Good Group (International) Limited – Interim illustrative financial statements

This publication contains the interim financial statements for a fictitious company, Good Group (International) Ltd, for the period ended 30 June 2010, based on IFRS in issue at 31 March 2010. The financial statements are cross-referenced to the source literature and include explanatory notes.

International GAAP® Disclosure checklist – March 2010

This publication is an update of International GAAP® Disclosure checklist, designed to meet the needs of clients and our client-service teams, contains all of the disclosure requirements for an entity filing either year-end or interim IFRS-based financial statements. The update contains all of the disclosure requirements issued as of 31 March 2010 should an entity wish to early adopt any standards and interpretations approved by the IASB.

IFRS Update April 2010

This publication summarises the new and amended IFRS standards and interpretations that are applicable to financial periods beginning on or after 1 July 2009. It also highlights other new and amended IFRS standards and interpretations that have been issued up to 31 March 2010 but are not yet effective.

IAS 36 Impairment of Assets – Impact, Issues and Valuation

Executive support and input is critical to manage stakeholders' expectations: impairment is not just an accounting exercise, it is an assessment of the business. In this publication, we provide an overview of the key requirements of IAS 36 *Impairment of Assets*, the primary differences with US GAAP, and the practical considerations for first time adopters of IFRSs.



Save the date: Ernst & Young financial reporting outlook conference 2010

Ernst & Young once again hosts its annual Financial Reporting Outlook conference in London on Monday 15 November 2010. The conference will focus on **Financial reporting – a year of change?** The last two years have stimulated debate on a number of accounting and regulatory issues likely to bring change to the world of financial reporting. The conference will provide an insight into the changing landscape of financial reporting, helping you prepare for the journey ahead. For more information please email financialreportingoutlook@uk.ey.com

IFRS webcast series

25 May 2010 – The lessons learned for year-end reporting

Although signs of recovery in the market have been evident since the beginning of 2010, businesses are still facing significant challenges in different areas including valuation for impairment and mark-to-market measurement. A panel of specialists will share their experiences from the 2009 reporting cycle and discuss the trends that are emerging from the released annual reports. This webcast is aimed at CFOs and controllers to enable them to take a proactive approach in the upcoming reporting season.

29 June 2010 – A new accounting model for insurers (subject to issue of exposure draft)

The new proposals for accounting for insurance contracts are likely to have a significant effect on all insurance companies as IFRS 4 *Insurance Contracts* is an interim standard that grandfathered accounting standards previously used. Our panel of experts will discuss the key aspects of the proposals and the potential impact these may have on the financial performance of insurers. An exposure draft is expected in May 2010.

Ernst & Young
Assurance | Tax | Transactions | Advisory

About Ernst & Young

Ernst & Young is a global leader in assurance, tax, transaction and advisory services. Worldwide, our 144,000 people are united by our shared values and an unwavering commitment to quality. We make a difference by helping our people, our clients and our wider communities achieve their potential.

Ernst & Young refers to the global organization of member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit www.ey.com

© 2010 EYGM Limited.
All Rights Reserved.

EYG no. AU0490

About Ernst & Young's International Financial Reporting Standards Group

The move to International Financial Reporting Standards (IFRS) is the single most important initiative in the financial reporting world, the impact of which stretches far beyond accounting to affect every key decision you make, not just how you report it. We have developed the global resources – people and knowledge – to support our client teams. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how Ernst & Young makes a difference.

In line with Ernst & Young's commitment to minimise its impact on the environment, this document has been printed on paper with a high recycled content.

This publication contains information in summary form and is therefore intended for general guidance only. It is not intended to be a substitute for detailed research or the exercise of professional judgment. Neither EYGM Limited nor any other member of the global Ernst & Young organization can accept any responsibility for loss occasioned to any person acting or refraining from action as a result of any material in this publication. On any specific matter, reference should be made to the appropriate advisor.