

IFRS outlook



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Our perspective on the proposals for accounting for non-financial liabilities

Earlier this year, the IASB issued new proposals on the measurement of non-financial liabilities. Discover what the key proposals are as well as our views on the proposed changes.

Keeping up to date on the status of IASB projects

The IASB and the FASB have set an aggressive timeframe for completion of their joint projects. Learn about the status of these projects and how you can stay up to date.

IFRS monthly update

In our new update section, we explain what's new this month from the IASB. We also highlight the projects currently being discussed by the IASB and the Interpretations Committee (formerly the Financial Reporting Developments section of *IFRS outlook*).

Resources

Look here for an up-to-date list of recent publications, including *IASB Projects - A pocketbook guide* which summarises the key features of the IASB projects. Register for our upcoming webcast on the new accounting model for insurers.

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

Ruth Picker
Global Leader of IFRS Services

Our perspective on the proposals for accounting for non-financial liabilities



The key proposals

- ▶ Liabilities will be measured based on the lower of the amount to fulfil, cancel or transfer the obligation
- ▶ The amount to fulfil an obligation:
 - ▶ Is the expected present value of resources required
 - ▶ Includes a profit margin for service obligations, including those to be self-fulfilled
- ▶ More likely than not, the probability recognition threshold has been removed

Ernst & Young's perspective

- ▶ We do not believe the proposals are an improvement over current requirements
- ▶ We disagree with proposals to:
 - ▶ Include a profit margin in the measurement for self-fulfilled service obligations – we recommend an expected cost measurement approach
 - ▶ Remove the probability recognition threshold

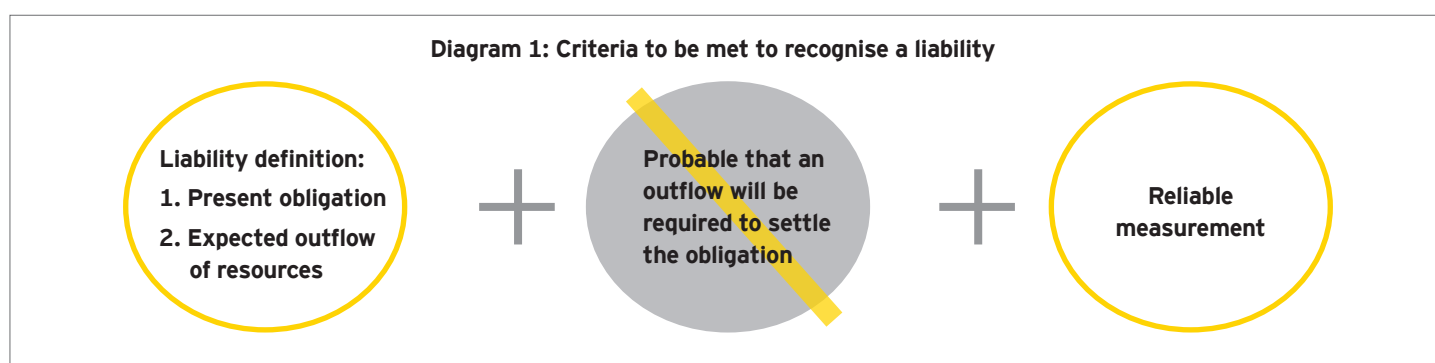
The International Accounting Standards Board (IASB) proposes to remove the “probable” recognition threshold for non-financial liabilities and to measure liabilities that are to be fulfilled by the entity at a price that includes a profit margin. We disagree with these proposals.

Earlier this year, the IASB issued a new exposure draft (ED) on the measurement of liabilities and published a working draft of the complete proposed IFRS. In this article, we comment on the proposals that are the most controversial and, in our view, are the greatest cause for concern – the proposals for recognition and measurement of a liability.

Should a liability be recognised?

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* recognition provisions have been amended to remove the requirement that it must be probable – more likely than not – that an outflow will be required to settle the obligation in order to recognise a liability. Removal of this criterion focuses attention on the definition of a liability in the *Framework* – a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits. This change is depicted in Diagram 1.

“The proposals drive an entity to a binary position - is there, on balance, a present obligation? There is no place for the answer “there may be”.”



In most cases, removal of the probable criterion will not yield different results from current practice because an entity will still need to determine whether a present obligation exists.

In other cases, such as in a legal dispute, it is often difficult to determine whether there is a present obligation. For example, before a dispute is finalised, it is not always clear whether the claim is valid and there is a present obligation. Additionally, management and their advisors typically do not provide a definitive statement that a claim has no merit. In these cases, it will be impossible to make an unreserved judgment that there is no valid claim.

The proposals drive an entity to a binary position - is there, on balance, a present obligation? There is no place for the answer “there may be”. So the new proposals may give rise to more situations where disputes are recognised as liabilities as highlighted in Table 1.

We do not believe that the removal of the probable criterion is an improvement over the current requirements and believe it should be retained.

Table 1: Potential outcomes of a legal dispute and whether a liability is recognised

Legal claim	Probable (more likely than not)?	Present obligation	Recognise liability	
			Proposals	IAS 37
Valid	Yes	Yes	Yes	Yes
May be valid	Yes	Yes ¹	Yes	Yes
May be valid	No	Yes ¹	Yes	No (contingent liability)
Invalid	No	No	No	No

¹ As the claim may be valid the entity cannot unequivocally assert that there is not a present obligation.

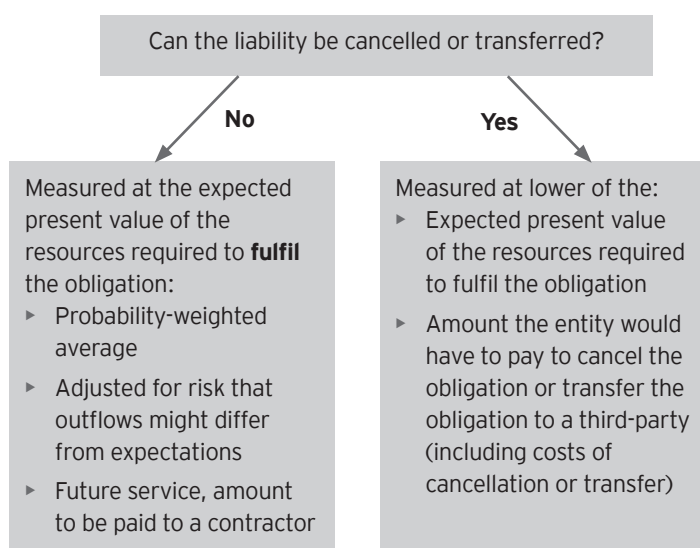
Our perspective on the proposals for accounting for non-financial liabilities

continued

Measuring the liability – what would an entity rationally pay to be relieved of a liability?

The measurement principle proposed by the IASB is consistent with that currently in IAS 37 – namely to measure a liability at the amount an entity would rationally pay to be relieved of it. In practice, this has been interpreted as ‘the most likely outcome’ or the minimum or maximum amount within a range, neither of which is consistent with how the IASB believes the liability should be measured. The IASB proposes to reduce this diversity by providing guidance as to exactly what amount an entity would rationally pay – specifically to measure the liability at the lower of the amount to fulfil, cancel or transfer it (see Diagram 2). This is a useful clarification of the measurement principle.

Diagram 2: ED proposals to determine the amount an entity would rationally pay to be relieved of an obligation



If the outflows required to fulfil the obligation are uncertain, the expected present value is calculated using the probability-weighted average of the possible outcomes discounted at market rates. An adjustment for risk is also assigned to adjust the present value calculated. This comprises the amount, if any, the entity would rationally pay in excess of the expected present value to be relieved of the obligation. This would require entities to determine each possible outcome – not just the most likely outcome – and assign a probability to it occurring. In our view, it is not clear to a reader what the probability-weighted amount represents; as it no longer represents an expected cash outflow. In any event, it is not clear how the risk adjustment relates to this assessment or how it should be determined.

The relevant outflows for a service obligation to be fulfilled are those that a contractor would charge to undertake the service. Consequently, the proposed measurement will always include a profit margin, whether or not the entity will fulfil the obligation itself or outsource it to a contractor.



Although these proposals attempt to provide a stronger framework for measuring liabilities, we, like the dissenting IASB Board members, disagree with the inclusion of a profit margin if the entity expects to self-fulfil the obligation for the following reasons:

- ▶ The amount recognised will not represent an estimate of the cash flows to be made, but will rather represent the 'value' of the obligation
- ▶ A profit will be recorded when the obligation is fulfilled. But we believe that services performed to fulfil an obligation as a consequence of operations, rather than from a contract with a customer, should not be income-generating

We agree with the dissenting IASB Board members who believe that **the amount an entity would rationally pay to be relieved of an obligation is the expected cost of fulfilling such obligation, using the fulfilment method determined by the entity** (i.e., self-fulfil or use a contractor). This measurement will provide more relevant and reliable information to users and will not require an imputed profit margin to be recognised.

Therefore, the inclusion of a profit margin in the measure, when combined with the probability-weighted average approach for possible outcomes, will not lead to an improvement in financial reporting in our view. All of these add a layer of complexity to measuring liabilities without adding the same level of benefits.

Ernst & Young's conclusion

We do not think the proposals are a significant improvement over the current requirements in IAS 37 because we disagree with the key proposals on recognition of liabilities and measurement of liabilities to be self-fulfilled. A provisional analysis of the comment letters submitted to the IASB indicates that there is also very little support from other respondents to these proposals.

The IASB will now analyse and discuss the feedback received, in addition to discussing the transitional provisions. Whatever the outcome, some change is likely to occur, providing greater clarity on the application of the measurement principle. All entities, regardless of what industry they are in, will be affected by future changes to liability recognition and measurement. We encourage you to monitor the project, the IASB's deliberations on the comments received, and consider how the proposals may change your accounting in order to plan for any forthcoming changes or comment on any future proposals.

Keeping up to date on the status of IASB projects

The onset of the financial crisis and ongoing efforts to converge IFRS and US GAAP have resulted in increased scrutiny of accounting standards by the financial community including governments, the G-20 and regulators. In addition, the political environment surrounding IFRS remains fragile, with sometimes conflicting demands of the standard-setters emanating from stakeholders, particularly in Europe and the US.

The IASB and the US Financial Accounting Standards Board (FASB) (collectively the Boards) are, nevertheless, trying to balance these demands and achieve the G-20's stated goal of one set of high quality global standards. The areas creating the most difficulty are financial instruments and insurance contracts where the Boards have not reached agreement with each other and prudential regulators are exerting pressure for the standards to meet financial stability objectives as a result of the financial crisis.

Under this spotlight, the IASB has laid out a work-plan for completion of a number of their more significant projects which can be broadly classified as follows:

Financial crisis related projects

- ▶ Consolidation
- ▶ Fair value measurement
- ▶ Financial instruments
- ▶ Derecognition

Memorandum of Understanding (MOU) projects

- ▶ Financial statement presentation
- ▶ Financial instruments with characteristics of equity
- ▶ Income taxes
- ▶ Leases
- ▶ Post-employment benefits
- ▶ Revenue recognition

Other projects

- ▶ Emissions trading schemes (joint project with FASB)
- ▶ Insurance contracts (joint project with FASB)
- ▶ Liabilities
- ▶ Management commentary
- ▶ Rate-regulated activities

The projects related to the financial crisis and the MOU are primarily joint projects between the IASB and the FASB. In addition, other projects, namely emissions trading schemes and insurance contracts have also been jointly undertaken by the Boards.

On a number of occasions, the Boards have affirmed a mid-2011 deadline for creating a global set of accounting rules for these projects. However, given the number of exposure drafts that would need to be released by the IASB and evaluated by constituents in such a relatively short period of time, stakeholders have voiced concerns about their ability to provide high quality input on such a large number of exposure drafts. As a result, the Boards have recently announced¹ that they are developing a modified strategy to take account of these concerns. This is expected to:

- ▶ Prioritise the major joint projects to permit a sharper focus on those that will bring about significant improvement and convergence between IFRS and US GAAP
- ▶ Stagger the publication of exposure drafts (and related activities such as public roundtable meetings) to enable broad-based and effective stakeholder participation in due process that is critically important to the quality of the standards
- ▶ Issue a separate consultation document seeking stakeholder input on effective dates and transition methods

¹ IASB – FASB Joint Statement on Convergence Work – June 2010.



The modified strategy is expected to retain the target completion date of June 2011 for many of the MOU projects, including those projects not in the MOU where a converged solution is urgently required. The target dates for other joint projects are expected to extend into the second half of 2011.

The Boards are expected to release their modified work plan strategy in the very near term.

In advance of the release of this modified strategy, the Boards have begun discussions with their respective oversight bodies and regulators including members of the IASC Foundation Monitoring Board. Importantly, it is expected that this action by the Boards will not negatively impact the US Securities and Exchange Commission's (SEC) work plan, announced in February 2010, to consider in 2011 whether and how to incorporate IFRS into the US financial system. SEC Chairman Mary L Schapiro issued the following statement² in response to the Boards comments about the modified strategy:

"The boards believe that the modified plan will contribute to increased quality in the standards because it provides additional time for stakeholders to thoroughly consider the proposals and give both boards quality feedback. I view this as time that is well invested.

Quality financial reporting standards established through an independent process are threshold criteria against which the Commission's future consideration of the role of IFRS in the US reporting system will be based. I foresee no reason that the adjustment to the targeted timeline for certain joint projects should impact the staff's analyses under the Work Plan issued in February 2010, particularly when that adjustment is designed to enhance the quality of the standards. Indeed, focused efforts on those standards the boards consider highest priority for the improvement of US GAAP and IFRS will facilitate the staff's analyses.

Accordingly, I am confident that we continue to be on schedule for a Commission determination in 2011 about whether to incorporate IFRS into the financial reporting system for US issuers."

Even under the proposed changes, we expect that the timelines for the various projects shown above will remain aggressive. Thus, the ability to stay one step ahead in a sea of change is critical. To assist you in keeping up to date on the status of the projects, Ernst & Young has published *IASB Projects – A pocketbook guide*. This quarterly publication provides a summary of the salient features of the proposed standards based on tentative decisions made to date, the potential financial and business implications and Ernst & Young's views on the respective projects. The publication can be downloaded at www.ey.com/ifrs.

² SEC Press Release, Release No. 2010 – 96, Chairman Schapiro Statement on FASB-IASB Decision to Modify Timing of Certain Convergence Projects.

IFRS monthly update

What's new this month?

The following table shows new publications issued by the IASB.

Projects	Publication	Status
Financial statement presentation	<p><i>Exposure Draft – Presentation of items of Other Comprehensive Income (Proposed amendments to IAS 1)</i></p> <p>The ED proposes that entities present profit or loss and other comprehensive income in separate sections of a single statement. It also proposes items in other comprehensive income are grouped on the basis of whether they will be 'recycled' to profit or loss at a future point in time.</p> <p>View the ED at www.iasb.org</p> <p>The Ernst & Young <i>Supplement to IFRS outlook</i> Issue 74 contains details of the proposals and can be downloaded at www.ey.com/ifrs</p>	Open for comment until 30 September 2010
Financial instruments	<p><i>FASB Exposure Draft – Accounting for Financial Instruments Proposed Update</i></p> <p>The US FASB has issued a proposed update on accounting for financial instruments to measure more financial instruments at fair value. The IASB is asking constituents to submit comment letters to the FASB on the proposals.</p> <p>The ED can be downloaded at www.fasb.org</p> <p>See <i>Supplement to IFRS outlook</i> Issue 73 for details of the FASB proposals. This can be downloaded at www.ey.com/ifrs</p>	Open for comment until 30 September 2010
Financial liabilities	<p><i>Exposure Draft – Fair Value Option for Financial Liabilities</i></p> <p>This ED proposes to retain the existing classification and measurement requirements of IAS 39 <i>Financial Instruments: Recognitions and Measurement</i> for financial liabilities with the exception of effects of changes in the own credit risk of a financial liability that an entity chooses to measure at fair value. Such changes will be recognised in other comprehensive income.</p> <p>View the ED at www.iasb.org.</p> <p>See <i>Supplement to IFRS outlook</i> Issue 72 for further analysis of the proposals. This can be downloaded at www.ey.com/ifrs</p>	Open for comment until 16 July 2010
Annual improvements	<p><i>Improvements to IFRSs</i></p> <p>The IASB has concluded the 2008-2010 cycle of amendments and issued an omnibus of amendments to six standards and one interpretation.</p> <p><i>Supplement to IFRS outlook</i> Issue 71 contains details of the amendments and can be downloaded at www.ey.com/ifrs</p>	Effective for annual periods beginning on or after 1 January 2011 unless otherwise stated



Current discussions

The IASB and the FASB held meetings on 4 May 2010 and from 17 to 20 May 2010.

Tentative decisions were made regarding a number of projects, including fair value measurement, consolidation, leases, insurance

contracts, and revenue recognition. A summary of the tentative decisions reached by the IASB can be found in the *IASB Update*, at www.iasb.org/updates/IASB+updates.

The following table reflects the current IASB work plan, however, as noted on pages 6 and 7, this work plan may change.

Project	Status
Fair value measurement	Limited scope ED of the measurement uncertainty analysis disclosure was expected May 2010
Consolidation	Limited scope ED of proposals regarding investment companies expected Q2 2010
Leases	ED expected June 2010
Revenue recognition	ED expected June 2010
Insurance contracts	ED expected June 2010
Financial statement presentation	ED was expected May 2010
Financial instruments with characteristics of equity	ED was expected May 2010

IFRS Interpretations Committee

The IFRS Interpretations Committee (the Interpretations Committee, formerly known as IFRIC) met in London on 6 and 7 May 2010. The committee discussed active projects on IAS 16 *Property, Plant and Equipment* – accounting for production phase stripping costs in the mining industry and IFRS 2 *Share-based Payment* – vesting and non-vesting conditions, and put options written over non-controlling interests. The Interpretations Committee also reviewed a number of potential agenda items.

Details of the decisions made at this meeting can be found in the *IFRIC Update* at www.iasb.org/Updates/IFRIC+Updates.

IASB Work Plan

The IASB Work Plan outlines all of the projects the IASB is currently working on, and includes projected publication dates. Further details of all the ongoing projects can be accessed at www.iasb.org/current+projects.

Resources

Supplements to *IFRS outlook*

Issue 72: Classification and measurement of financial liabilities – new IASB proposals

As part of the ongoing project to replace IAS 39 *Financial Instruments: Recognition and Measurement*, the IASB has published an exposure draft containing proposals for the classification and measurement of financial liabilities. The Board's proposal is to retain the existing classification and measurement requirements in IAS 39 for financial liabilities, with two exceptions: the effects of changes in own credit risk will not affect profit or loss for financial liabilities designated at fair value through profit or loss using the fair value option; and liabilities arising from derivatives on investments in unquoted equity instruments will no longer be measured at cost. The accounting for most financial liabilities will not change, and the complexity caused by the IAS 39 rules for separating embedded derivatives will continue to exist. In addition, the Board's current proposal will result in asymmetrical treatment of financial assets and financial liabilities. This Supplement to *IFRS outlook* summarises key elements of the proposals and the key business impact expected.

Issue 73: IASB requests feedback on FASB's proposals to increase use of fair value accounting for financial instruments

The US Financial Accounting Standards Board (FASB) released new proposals on accounting for financial instruments. If adopted as proposed, this would be a significant change from current US GAAP because many more financial instruments, including loans, will be measured at fair value. Although the project on financial instruments is part of the global convergence project committed to by the IASB and the FASB, the two Boards have been deliberating issues separately and have reached significantly different conclusions. In line with the commitment to converge, the IASB has asked its constituents to submit comment letters to the FASB on its proposals, so that the FASB can consider the feedback from the international community when re-deliberating its proposals. In this publication, we summarise some of the main differences between the approaches adopted by the two Boards. Comments and feedback on the Proposed Update are due to the FASB by 30 September 2010.

Issue 74: Proposed changes to the presentation of other comprehensive income

The IASB has issued for comment an Exposure Draft (ED/2010/5) *Presentation of Items of Other Comprehensive Income* (amendments to IAS 1 *Presentation of Financial Statements*), proposing limited changes to the presentation of other comprehensive income (OCI). The ED proposes two key changes to IAS 1. The first is to present a single statement of comprehensive income containing two distinct sections for profit or loss and other comprehensive income, thereby eliminating the current option of presenting two separate statements. The second significant change proposes a new presentation approach for items within OCI. Items that would be reclassified (or 'recycled') to profit or loss at a future point in time (for example upon derecognition or settlement) would be presented separately from items which will never be reclassified. Comments on the exposure draft are due by 30 September 2010.

Insurance Accounting Alert May 2010

The IASB and FASB (the Boards) discussed insurance contracts on 18 and 19 May. The Boards sought to resolve a number of open issues including margins, level of measurement and unbundling in order to meet their timetable for issuing an Exposure Draft (ED) of a new insurance standard in July 2010. This alert summarises the discussions the Boards have had thus far.

IASB Projects – A pocketbook guide

This quarterly guide summarises the key features of the various IASB projects, many of which are joint projects with the FASB as part of ongoing efforts to converge IFRS and US GAAP. In particular, the pocket guide summarises the proposed standards based on the tentative decisions taken to date and sets out some of the potential financial and business implications of these decisions, together with Ernst & Young's views on the projects. The time lines for completion of the various projects are aggressive and the ability to stay one step ahead in a sea of change is critical. Furthermore, the accounting changes arising from the introduction of these proposed standards are extensive and it is critical that feedback on potential issues is shared with the IASB before the standards become effective.



Archived webcast

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 shared their experiences from the 2009 reporting cycle and discussed the trends that have emerged from the released annual reports. The webcast is aimed at CFOs and controllers to enable them to take a proactive approach in the upcoming reporting season.

Coming soon

Forthcoming IFRS webcasts

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 June 2010. To register for this webcast, go to ey.com/ifrs and follow the links.

Advertising and sponsorship

Accounting for promotional costs in consumer products companies under IFRS

Many consumer products companies spend significant amounts on marketing and promotion, often on campaigns that run over a number of years. In the light of recent IASB clarifications about the timing of the recognition of advertising and promotion costs, this publication considers some of the accounting principles relating to these costs and the steps that management needs to take to find a sound accounting treatment under IFRS for these activities.

Key IFRS accounting developments for banks

Following the global financial crisis, a spotlight was focused on the complexity of accounting for financial instruments under IFRS. The IASB has accelerated its project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and amend or replace several other standards. This publication provides an overview of some of the recent IFRS accounting developments and considers their potential impact for banks.

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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.

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