

# IFRS news

Emerging issues and practical guidance\*

Issue 79 – November 2009

## IASB issues impairment ED draft

John Althoff, John McDonnell and Yulia Feygina of PwC's Accounting Consulting Services explain the implications of the impairment ED issued earlier this month by the IASB.

### What is the issue?

The IASB is proposing fundamental changes to the impairment guidance for financial assets accounted for at amortised cost. This is the second stage of the IAS 39 replacement project. The ED proposes an 'effective return' approach to amortised cost measurement. For financial assets, this implies an 'expected cash flow' (ECF) impairment model.

The proposed approach is built upon the premise that interest charged on financial instruments includes a premium for expected losses, which should not be included as part of interest revenue/income, and results in an allocation of the initial estimate of expected credit losses over the expected life of the financial asset. The lender will be required to identify the 'effective interest rate' (EIR) component at the inception of an instrument that represents compensation for the expected losses. Interest income is recognised over the life of the instrument at the EIR, net of the expected loss component identified at inception. The premium associated with the expected losses is reflected each period as a reduction in the basis of the receivable (effectively a provision for bad debts).

Unlike the incurred loss model currently required under IAS 39, the ECF approach does not wait for evidence that an impairment has occurred, but instead requires a continuous assessment of the expected cash flows over the life of the instrument. No impairment losses will be recognised if the original expectations of the expected losses prove accurate. The premium associated with the initial estimate of expected losses will have already reduced the receivable balance to the amount expected to be collected. However, if more losses are expected than originally estimated, an impairment charge will be recognised for the decrease in the expected cash flows. If favourable changes to loss expectations occur, a credit to income will be recognised for the increase in expected cash flows. The approach requires the use of allowance account for credit losses. Direct write-offs are prohibited.

The ED sets out robust presentation and disclosure requirements to ensure that users can evaluate the financial effect of interest revenue and interest expense, and the credit quality of financial assets held by the entity. In particular, it requires:

- Presentation of the gross contractual interest revenue, a reduction to gross interest revenue reflecting the portion of initial expected credit losses allocated to the period, and a subtotal for the net (economic) interest revenue;
- Presentation of gains and losses resulting from changes in estimates in relation to financial assets and liabilities measured at amortised cost;
- Reconciliation of changes in credit loss allowance account (with minimum required line items) and the entity's write-off policy;
- Disaggregation of gains and losses into amounts attributable to changes in credit loss expectations and other factors;

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- Comparison between the development of credit loss allowance over time and cumulative write-offs (a loss triangle);
- Explanation of inputs, assumptions and methodology used in determining expected credit losses and changes there to, sensitivity analysis, and stress-testing if performed internally;
- Reconciliation in the movement of non-performing loans (defined as 90 days or more overdue);
- Origination and maturity (vintage) information for financial assets at amortised cost;
- Further qualitative and quantitative disclosures depending on the entity's specific circumstances.

The IASB recognises that there are significant operational challenges in implementing and applying the ECF approach. Estimating cash flows over the life of the instrument and the complexity of the EIR methodology are expected to be two of the most difficult areas. The IASB is therefore setting up an Expert Advisory Panel to advise the Board on the operational issues surrounding application of the ECF approach and possible practical expedients and to facilitate field testing. The ED has an unusually long exposure period, with comments requested by 30 June 2010. This long exposure period is to facilitate the work of the Expert Advisory Panel. The Expert Advisory Panel will consider both the IASB and FASB impairment models.

The FASB impairment model is still under development and both Boards would like the impairment guidance to arrive at similar outcomes. However, a 'converged' impairment standard may be a challenge if the broader financial instruments guidance of the IASB and the FASB is not converged.

A final IFRS on amortised cost and impairment is expected by the end of 2010. The Board expects that the IFRS will not become mandatory until about three years after it is issued.

### Am I affected?

All entities that hold financial assets carried at amortised cost will be affected. The proposals will have the greatest impact on banks and other financial institutions that have significant investments in loans and receivables. The proposed model will equally apply to trade receivables routinely held by entities that are not financial institutions, so corporate entities should also evaluate the effect of the proposals.

Entities transitioning to IFRS before the proposed effective date need to consider the implications of the proposals on their transition plans. First-time adopters should consider if they need to implement systems that will comply with the current IAS 39 incurred loss model in light of the proposed expected loss model, which would require further systems changes.

### What do I need to do?

The IASB is seeking comments on the ED by 30 June 2010. We encourage management to reply, giving special consideration to the operational side of the expected cash flow approach and 'field testing' the model. We also encourage you to follow the discussions of the Expert Advisory Panel, as these will provide the basis for the detailed operational guidance in the final standard.

## Publications for the year-end now available

### Illustrative IFRS corporate consolidated financial statements for 2009 year-ends

The financial statements of a fictional company have been updated to illustrate the disclosure and presentation requirements of the IFRS standards and interpretations for financial years beginning on or after 1 January 2009. The company is an existing preparer of IFRS financial statements.

We have provided additional commentary to explain the detail behind the presentation of a number of challenging areas. These commentary boxes relate to the presentation in: the balance sheet; the income statement and statement of comprehensive income; the statement of changes in equity; the statement of cash flows; the summary of significant accounting policies; and financial risk management.

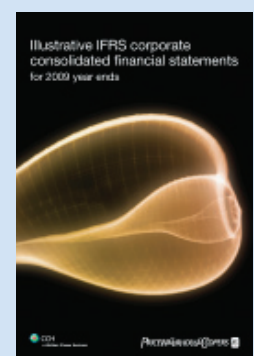
### IFRS disclosure checklist 2009

The IFRS disclosure checklist has been updated to take into account standards and interpretations amended or issued up to 17 October 2009.

Disclosure requirements resulting from standards and interpretations that have been issued and are effective for annual periods beginning on or after 1 January 2009 are included in the main section. Other sections set out the disclosure requirements of standards and interpretations that are in issue at 1 January 2009 and are effective for annual reporting periods beginning on or after 1 July 2009.

Both old and new IAS 1 (revised) terminology is used in the checklist.

Hard copies of both these publications can be ordered through your PricewaterhouseCoopers contact; the PDFs can be downloaded at [www.pwc.com/ifrs](http://www.pwc.com/ifrs).





## IASB relaxes IAS 24 disclosures

The IASB published an amendment to IAS 24, 'Related-party disclosures' last month, relaxing disclosures of transactions between government-related entities and clarifying the definition of related-parties. Tony Debell, leader of Global ACS, 'Revenue, liabilities and other' topic team and Yvonne Kam in Global ACS in Hong Kong/China, look at the implications.



The amendment removes the requirement for government-related entities to disclose details of all transactions with the government and other government-related entities. It also clarifies and simplifies the definition of a related party.

### Government-related entities

Government-related entities are now defined as entities that are controlled, jointly controlled or significantly influenced by the government. The previous version of IAS 24 did not contain any specific guidance for government-related entities. They were therefore required to disclose transactions with the government and other government-related entities. This requirement was onerous in territories where government control is pervasive; it placed a significant burden on entities to identify related-party transactions and collect the information required to make the disclosures. For example, a government-controlled railway was theoretically required to disclose details of its transactions with the post office. This information is not necessarily useful but is costly and time-consuming to collect.

The financial crisis widened the range of entities subject to the related-party disclosure requirements. The financial support provided by governments to financial institutions in many countries means that the government now controls or significantly influences some of those entities. A government-controlled bank, for example, would be required to disclose details of its transactions deposits and commitments with all other government-controlled banks and with the central bank.

The amendment introduces an exemption from all of the disclosure requirements of IAS 24 for transactions between government-related entities and the government, and all other government-related entities. Those disclosures are replaced with a requirement to disclose:

- (a) the name of the government and the nature of their relationship; and
- (b) (i) the nature and amount of any individually-significant transactions; and
  - (ii) the extent of any collectively-significant transactions qualitatively or quantitatively.

This is a significant relaxation of the disclosure requirements and should be of substantial benefit to government-related entities. The complexity and volume of the disclosures and the costs of record-keeping will be reduced. The new disclosures will provide more meaningful information about the nature of an entity's relationship with the government and material transactions.

### Definition of a related party

The previous definition of a related party was complicated and contained a number of inconsistencies. These inconsistencies meant, for example, that there were situations in which only one party to a transaction was required to make related-party disclosures. The definition has been amended to remove the inconsistencies and to make it simpler and easier to apply.

The amended definition means that some entities will be required to make additional disclosures. For example, a subsidiary is now required to disclose transactions with an associate of its parent. An entity that is controlled by an individual that is part of the key management personnel of another entity is now required to disclose transactions with that second entity.

The amendment will make the definition of a related party easier to apply, but some entities will have to make additional disclosures.

### Am I affected?

The amendment will affect the disclosures required of all government-related entities. This burden will be significantly reduced and replaced with more useful summarised information and details of significant transactions.

The revised definition of a related party will mean that some entities will have more related parties and will be required to make additional disclosures. The entities that are most likely to be affected are those that are part of a group that includes both subsidiaries and associates and entities with shareholders that are involved with other entities.

### What do I need to do?

The revised standard is effective for annual periods beginning on or after 1 January 2011; earlier application is permitted, for either the entire standard or the government-related entity exemption. Management of government-related entities should consider immediately whether to adopt the amendment in 2009. Early adoption is likely to be attractive for many entities, but management that intends to adopt early should also consider the revised disclosure requirements and put in place procedures to collect the required information.

Management of other entities should consider the revised definition to determine whether any additional disclosures will be required and put in place procedures to collect that information.

## IAS 39 replacement due out this month

IASB chairman Sir David Tweedie has confirmed that the Board will publish the IAS 39 replacement standard (IFRS 9) this month. He told the European Finance Ministers in a speech last month that the final standard is likely to result in financial institutions that undertake traditional banking activities (raising deposits and making basic loans – the so-called ‘boring banks’) applying less fair value accounting rather than more.

Other features of the standard that he highlighted in the speech are:

- More instruments will be eligible for measurement at cost than was proposed in the exposure draft.
- The assessment of the business model should be the first factor in determining the classification of financial instruments. The prohibition on reclassification of financial instruments that was in the original proposal has been removed in response to suggestions that a change in business model should result in reclassification.
- Reclassification of financial instruments out of the fair value option will be possible on transition when making new designations.
- Insurance companies will not be required to adopt the new standard until 2013 or 2014 at the earliest. This will enable the Board to address any implications for the accounting for financial instruments by insurance companies once the insurance contracts project is nearer completion.
- The Board has made improvements to the original proposal in relation to dividends on equity investments and the

measurement of unquoted equity investments. In a change to the ED, the Board tentatively decided to require recognition of dividends received from these investments in profit or loss. The Board also tentatively reconfirmed that recycling of gains and losses between profit or loss and other comprehensive income will be prohibited.

Sir David also confirmed the IASB commitment to work with the FASB on a common approach to accounting for financial instruments. The two Boards discussed the work plan and principles of convergence on financial instruments at their joint meeting in Norwalk. The IASB will review the presentation and disclosure requirements of the classification and measurement standard early next year when the FASB issues its ED on financial instruments. The IASB aims to bridge the gaps between the two classification and measurement models. The Boards have also expressed their intention to work together on impairment, hedging and accounting for financial liabilities. A financial instruments standard incorporating these issues is due by the end of 2010.

## Cannon Street Press

### IASB to discuss convergence on FV measurement

The IASB is planning to re-debate some of the issues arising from its recent ED on fair value measurement. Respondents from emerging markets have expressed concern over the lack of markets, market data and skilled valuers needed to apply the proposals. Many respondents also expressed concerns over the differences between IASB and FASB requirements. The IASB has agreed to address these concerns and is meeting with the FASB to discuss convergence of the US and IFRS standards.

Roundtable debates on the fair value measurement project will take place this month in Norwalk and Tokyo, and in London in December. The IASB will re-deliberate the issues raised by the comment letters and the roundtables in January.

### IASB and FASB agree to align consolidation requirements

The IASB and FASB have announced their intention to converge their guidance on consolidation, with new standards expected from both Boards in 2010. This means a delay to the publication of the IFRS standard while the Boards debate the current points of difference and the FASB prepares its ED. The FASB is due to release its ED in quarter 2 next year. This delay to the IASB’s consolidation standard is not expected to affect the publication of the joint venture standard due later this year.

### IASB abandons draft amendment on discount rate for employee benefits

The IASB has decided to abandon the draft amendment on setting the discount rate for employee benefits.

The ED, published in August 2009, was intended to improve comparability in financial statements by using the high-quality corporate bond rate for employee benefits, whether this was a deep market or not. It was targeted to be a fast-track amendment, with implementation before 31 December 2009.

The Board decided to abandon the amendment, as there was broad disagreement from the respondents. The current guidance on discount rate in IAS 19 still applies.

Where there is no deep market in high-quality corporate bonds – such as Sweden, Australia, South Africa and Hong Kong – entities should still use government bond yields to determine the discounted employee benefit obligations. Management cannot use an estimated high-quality corporate bond rate where there is no deep market.

Setting the discount rate assumption can be challenging in current economic conditions. It is important to ensure that there is a robust and sound methodology in place for this process.



## Beginners' guide: how to be a member of an audit committee

What does an audit committee do? What makes a good audit committee member? Monica Peters, Corporate Governance manager within PwC's Audit, Risk and Quality group in the UK, looks at how joining an audit committee can be challenging and interesting but warns that it's not for the faint-hearted.

### What is an audit committee?

An audit committee is an important committee of the board with responsibility for overseeing the financial reporting process, among other things. An effective audit committee is a key feature of a listed company's corporate governance framework and can bring significant benefits to the company. A public company may have an audit committee as a requirement imposed by law, listing rules, a good practice code or voluntarily to demonstrate a commitment to good corporate governance. The specific requirements and rules for the audit committee will differ depending on the jurisdiction and the company's specific circumstances, but there are many common features and requirements.

There is no optimum size for an audit committee; the size and complexity of the company, and the extent of responsibility delegated by the board to the committee, will indicate the optimum size beyond the basic requirements. Local codes and regulations may make recommendations or have requirements: the Combined Code in the UK, for example, recommends that there should be at least three members (two, for smaller companies) who must be independent non-executive directors.

Independence is seen as crucial for a successful audit committee. Financial expertise is another core attribute; at least one member of the audit committee should have recent and relevant financial experience. Local regulations may also apply – for example, the UK Disclosure and Transparency Rules require at least one member to be independent, and at least one member (not necessarily the same member) to have competence in accounting and/or auditing. In the US, one member must be identified in the annual report as the 'financial expert'.

### What does an audit committee do?

The primary responsibility of the audit committee is to oversee the company's financial reporting process, and to monitor the integrity of the financial statements and any formal announcements made in relation to the financial statements. The audit committee should meet three or four times a year (or more, as required), aligned to the financial reporting cycle. The audit committee should review and understand the significant accounting financial reporting judgements contained in the financial statements. It should also supervise the system of internal financial controls and (unless there is a separate risk committee) the internal control and risk management systems. It is also responsible for oversight of the internal audit function.

### Features of an audit committee

- Monitors the integrity of the financial statements.
- Reviews the effectiveness of the internal control, risk management systems and the internal audit function.
- Oversees the external audit of the annual financial statement
- Monitors the independence of the external auditor, including setting and implementing policies for any non-audit services provided by the auditor.
- Reviews the company's whistle-blowing policy and ensures arrangements are in place for independent investigation and appropriate follow-up action.
- Size can vary; at least one member should have financial experience, and at least one member should be 'independent'.
- Meets three to four times a year or more often if necessary.

One of the key responsibilities of the audit committee is managing the relationship with the external auditors; making recommendations to the board on the appointment, re-appointment and removal of the external auditors; monitoring the external auditor's independence and objectivity; reviewing the external audit process; and developing and implementing the policy on the supply of non-audit services by the auditors.

It is fundamental for the committee members to understand the financial statements, the significant accounting principles underlying them, and the audit process. The audit committee's independence is of crucial importance when overseeing the financial reporting integrity and for evaluating issues where the judgements and decisions about alternative accounting options are significant. Being independent allows the audit committee members to act in a supervisory capacity, challenging management, without any conflicts of interest arising between the interests of the company and their own personal interests.

### What makes a good audit committee member?

Audit committee members should possess a range of skills and experience, preferably gained from within a business or professional environment. It is helpful to have some financial background and, as mentioned above, it is common for at least one member to have recent and relevant financial experience. It would also be an advantage for one or more members to have specialised knowledge of the company's particular industry. This helps the audit committee members to fully understand the business issues facing management on a daily basis and makes it more likely that the members have an appreciation of the problematic accounting issues in the sector.

The role of the audit committee and the demands placed on members mean that audit committee members ideally should have strong interpersonal skills, be able to communicate clearly and effectively, and have high professional standards and sound judgement. They should have an enquiring mind, be prepared to challenge constructively other people's views and assumptions, be able to stand their ground and defend their own viewpoint, ask intelligent questions and not be afraid of asking what might seem an obvious question.

A successful audit committee member is likely to be someone who devotes sufficient time and commitment to understand the company and its business. He or she would also be willing to participate fully at audit committee meetings and to ask probing and challenging questions of management. In addition, he or she would also take active steps to keep themselves up to date with current developments in financial and non-financial reporting and corporate governance.

### You are joining an audit committee; what do you do first?

Non-executive directors are well compensated for their services, and membership of the audit committee is both prestigious and interesting. You get the phone call inviting you to join the audit committee of a large listed company. Time to break out the champagne? Maybe so, but not until after you've done some due diligence. It is important to have a good understanding of the business and the financial reporting issues at the company. Check for any conflicts of interest that would compromise your independence or that would create a perception of a lack of independence. You should ensure that you are up to date in your knowledge of financial reporting. You don't need to know the technical details of all the accounting standards, but having a broader awareness of the current debates and the likely controversial areas for the particular company will be important. You might also wish to research the background of the other members of the board, including the other audit committee members and its chairman.

The audit committee must receive the information and reports it needs, in the format and level of detail it needs, to make decisions. This might not be the same as the information and reports that management want to provide to the audit committee. Members of the audit committee may need to insist that such information is received in a timely manner and appropriate format.

An audit committee can come under serious scrutiny for a company's financial reporting practices, particularly when accounting hits the headlines, comes in for regulatory attention or there is a surprise corporate failure. The audit committee of Enron, one the largest corporate failures in history, attracted severe criticism from a number of sources for how it discharged its responsibilities (see box below).

Joining the audit committee: challenging and interesting, but not for the faint-hearted.

#### Excerpt from 'The Powers Report: A Report of Investigation by the Special Investigative Committee of the Board of Directors of Enron Corp'.

The Audit and Compliance Committee, and later the Finance Committee, took on a specific role in the control structure by carrying out periodic reviews of [specific] transactions. This was an opportunity to probe the transactions thoroughly, and to seek outside advice as to any issues outside the Board members' expertise. Instead these reviews appear to have been too brief, too limited in scope and too superficial to serve their intended function... The Board, and in particular the Audit and Compliance Committee, has the duty of ultimate oversight over the Company's financial reporting. While the primary responsibility for the financial reporting abuses discussed in the report lies with Management, the participating members of this Committee believe those abuses could and should have prevented or detected at an earlier time had the Board been more aggressive and vigilant.

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## Impairment lessons learnt in latest reporting cycle

### What is the issue?

The economic storm of the past 18 months has impacted many aspects of financial reporting, not least the impairment of non-financial assets. Some common themes have emerged from the many impairment queries we have discussed with entities, which management may like to consider ahead of finalising the next set of accounts.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

### Who does it impact?

All entities with non-financial assets that are likely to be impaired in the next reporting period.

### What are the common impairment issues?

**Timing of the impairment test.** The impairment testing process for goodwill takes time as it involves estimating the cash flows, determining the discount rates, testing the reasonableness of the assumptions and benchmarking the assumptions with the market. As a result, many entities begin this process well in advance of year end. If an impairment trigger arises for goodwill between the date of the annual test and the year end, the goodwill will have to be re-tested for impairment. Entities can avoid redoing the test by planning the annual impairment test for goodwill sufficiently close to year end ensuring the test results are materially correct at year end.

**Determining the discount rate.** The choice of discount rate is a powerful factor in whether or not an impairment loss is recognised. Be wary of illogical discount rates; any decreases in discount rates should be queried and compared with valuation trends in the wider market. A common misconception in the past year has been to assume that a fall in short-term risk-free rates will feed through to lower discount rates for impairment testing. However, while short-term, risk-free rates have fallen sharply, longer-term risk-free interest rates haven't fallen nearly so much.

Risk premiums and credit spreads have increased dramatically. Discount rates produced using a weighted average cost of capital (WACC) model have been higher in the current year than previously. This makes sense, as the discount rate aims to measure the risk inherent in the assets being tested for impairment.

**Value in use (VIU) and pre-tax discount rates.** To perform the VIU calculation, IAS 36 requires entities to use pre-tax cash flows and a pre-tax discount rate. However, in practice many entities use post-tax cash flows and a post-tax discount rate to determine the VIU of their CGUs and 'back solve' for the pre-tax rate, because most of the readily available market rates for equity are post tax. Nevertheless, to comply with the standard, entities need to disclose the pre-tax discount rate that would apply to their VIU calculation. Identifying the pre-tax discount rate is not a matter of simply grossing up the post tax discount rate with the standard rate of tax. Entities should consider the timing of the future cash flows, the useful life of the CGU, and the expected tax cash outflows in deriving the discount rate.

**Disclosure.** Entities that are not recognising impairments when their market capitalisation is below net asset value should be able to explain their position convincingly to the stakeholders. Providing robust disclosures about the sensitivities of management's key assumptions used in impairment tests can help overcome some of the market scepticism. Impairment is on regulators' radar and their first line of sight will be on entities' impairment disclosures.

### PwC insight: Don't overlook the good news!

Given the prolonged market downturn, many entities will be expecting to record an impairment loss in the current reporting period. However, some entities will need to consider if any impairment losses, for example of their property, plant or equipment, from a previous period should be reversed due to unexpected favourable changes that have occurred in their operating environment. For example, let's say an entity recognised an impairment loss because it expected the price of its products to fall in the medium term. However, the market has picked up and there is now an increase in demand (and an increased price) for the entity's product. In this case, management will need to assess whether the entity's original impairment loss except for goodwill should be reversed.