

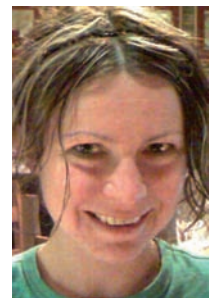
IFRS news

Emerging issues and practical guidance*

Issue 80 – December 2009/January 2010



IFRS 9: new requirements for financial assets



The IASB issued IFRS 9, 'Financial instruments', last month, addressing classification and measurement of financial assets. The leader of PwC's Global Accounting Consulting Services financial instruments topic team, John Althoff, and Yulia Feygina from the Global ACS Central team, look at the impact.

What is the issue?

The major changes to existing guidance in IAS 39 are outlined below.

- IFRS 9 replaces the multiple classification and measurement models in IAS 39 with a single model that has only two classification categories: amortised cost and fair value. Classification under IFRS 9 is driven by the entity's business model for managing the financial assets and the contractual characteristics of the financial assets. A financial asset is measured at amortised cost if two criteria are met: a) the objective of the business model is to hold the financial asset for the collection of the contractual cash flows, and b) the contractual cash flows under the instrument solely represent payments of principal and interest.
- The new standard removes the requirement to separate embedded derivatives from financial asset hosts. It requires a hybrid contract to be classified in its entirety at either amortised cost or fair value. Most embedded derivatives introduce variability to cash flows. This is not consistent with the notion that the instrument's contractual cash flows solely represent the payment of principal and interest. Most hybrid contracts with financial asset hosts will therefore be measured at fair value in their entirety.
- Two of the existing three fair value option criteria become obsolete under IFRS 9, as a fair value driven business model requires fair value accounting, and hybrid contracts are classified in their entirety. The remaining fair value option condition in IAS 39 is carried forward to the new standard – that is, management may still designate a financial asset as at fair value through profit or loss on initial recognition if this significantly reduces an accounting mismatch. The designation at fair value through profit or loss will continue to be irrevocable.
- IFRS 9 prohibits reclassifications except in rare circumstances when the entity's business model changes; in this case, the entity is required to reclassify affected financial assets prospectively.

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- There is specific guidance for contractually linked instruments that create concentrations of credit risk, which is often the case with investment tranches in a securitisation. In addition to assessing the instrument itself against the IFRS 9 classification criteria, management should also ‘look through’ to the underlying pool of instruments that generate cash flows to assess their characteristics. To qualify for amortised cost, the investment must have equal or lower credit risk than the weighted-average credit risk in the underlying pool of instruments, and those instruments must meet certain criteria. If ‘a look through’ is impracticable, the tranche must be classified at fair value through profit or loss.
- IFRS 9 classification principles indicate that all equity investments should be measured at fair value. However, management has an option to present in other comprehensive income unrealised and realised fair value gains and losses on equity investments that are not held for trading. Such designation is available on initial recognition on an instrument-by-instrument basis and is irrevocable. There is no subsequent recycling of fair value gains and losses to profit or loss; however, dividends from such investments will continue to be recognised in profit or loss.
- IFRS 9 removes the cost exemption for unquoted equities and derivatives on unquoted equities but provides guidance on when cost may be an appropriate estimate of fair value.

IFRS 9 represents the first milestone in the IASB’s planned replacement of IAS 39. The next steps involve reconsideration and re-exposure of the classification and measurement requirements for financial liabilities, further exploration and field testing of the proposed impairment approach for financial assets, and development of enhanced guidance on hedge accounting. The IASB is also likely to publish a request for views on the FASB comprehensive exposure draft on financial instruments, which is expected to be issued in the first quarter 2010. The IASB aims to fully replace IAS 39 by the end of 2010.

Who is affected?

Banks and insurance companies will be most significantly impacted by the new standard, but all entities that hold financial assets will be affected. The degree of the impact will depend on the type and significance of financial assets held by

the entity and the entity’s business model(s) for managing financial assets.

The effective date of the new classification and measurement guidance is 1 January 2013; early application is permitted. IFRS 9 should be applied retrospectively; however, if adopted before 1 January 2012, comparative periods do not need to be restated. In addition, entities adopting before 1 January 2011 are allowed to designate any date between then and the date of issuance of IFRS 9, as the date of initial application that will be the date upon which the classification of financial assets will be determined.

What does management need to do?

The standard is available for early adoption immediately. Management should familiarise themselves with the detailed requirements of IFRS 9 and evaluate the effects of the new standard on the classification and measurement of financial assets held by the entity. Management should consider the potential benefits of early adoption of the new guidance in light of the provided relief from restatement of comparative information and the relaxed requirements for the determination of the date of initial application for early adopters.

However, management should bear in mind that the financial instruments project is evolving. The IASB has indicated that the effective date of IFRS 9 may be pushed back to align the mandatory adoption of the standard with the effective dates for IAS 39 replacement stage II – ‘Amortised cost and impairment’ and ‘Insurance’ projects. In addition, there may be changes in the financial statements presentation for financial assets to enable investors to more easily reconcile the IASB and FASB models.

Management and other interested parties should monitor the IAS 39 replacement project and consider the impact of further decisions in the context of requirements already established by IFRS 9.

European companies will want to follow the endorsement process by the European Commission. We understand that EFRAG has decided that more time should be taken to consider the output from the IASB project to improve accounting for financial instruments. Therefore, at this stage, EFRAG will not finalise its endorsement advice to the European Commission on IFRS 9.



Impairment again?! Why the continued focus?

Regulators scrutinise impairment disclosures and look for impairments in financial statements. But impairment charges do not move the share price because the market factors these into the share price before the impairments are recognised. Dave Walters from PwC's Accounting Consulting Services in the UK looks at the ongoing marketplace and regulatory scrutiny and offers some reminders of good practice.

Regulators focused heavily on disclosures in the 2008 reporting season. The consensus is that impairment disclosures have improved; there is nothing like a near-miss to sharpen the mind. Some regulators gave notice that they would be scrutinising these disclosures, so the improvement is not that surprising.

Market data indicates that the number of companies announcing impairments at or near the 2008 calendar year-end was higher than in recent years but was still lower than many anticipated. Although prices in equity markets have increased in recent months, is this sufficient to preclude future waves of impairment?

Impairment is a live issue. Management should continue to be alert to regulatory scrutiny and marketplace sentiment around impairments and impairment disclosures.

The marketplace often prices in the impairments before they are recognised in the financial statements. Separate research projects indicate that the impact of downward movements in cash flow expectations is likely to be built into the share price prior to any accounting impairment charges being announced. Impairment charges booked in the financial statements may simply reflect information and knowledge that is already incorporated into analysts' expectations. A key indicator that the market may expect an impairment charge is the company trading below book value.

Impairment is not a foregone conclusion in current conditions, but management should be able to explain the differences between book value and market capitalisation.

With marketplace and regulatory scrutiny continuing, now may be a good time for some reminders of good practice.

- A return to normalised operations will take time, and forecast normal levels of profitability may be different from the levels experienced in late 2007/early 2008. Many experts believe it will take years for G20 economies to return to pre-credit crisis levels.

- The financial crisis hit right across the world and across industries. The recovery is therefore likely to return to different territories and different industries at different times.
- We now have evidence of forecasting accuracy in the downturn given the past year's results, which should be assessed relative to the 2009 budgets. This will be important evidence when considering the reasonableness of the forecasts being used in impairment models.
- An equity trading price below book value is only one potential trigger; changes in other assumptions such as long-term growth rates, currency fluctuations, market share, etc. need to be carefully assessed at each reporting period.
- The cost of capital was a key discussion point last year and will remain a material assumption in this year's impairment analyses. We do not expect significant changes to the cost of capital (that is, the cost of capital in general has not decreased during the past 12 months).

Considering the sweeping nature of the financial crisis, the downward revisions to earnings estimates across many industries and the continued focus on the topic from the regulators, impairment and robust impairment disclosures will continue to be a hot topic for 2009 financial reporting.

Impairment: current issues

- Level of impairments taken was lower in 2008/09 than many had feared.
- Equity prices are still not at pre-credit crunch levels despite recent increases.
- Continued focus is required on key valuation inputs and robustness of forecasts.
- Trading conditions remain challenging and therefore companies may still miss their forecasts.
- Cost of capital in general remains high.
- Goodwill and intangible impairments continue to be on the agenda of regulators.

Cannon Street Press

IASB to release ED on measurement guidance to replace IAS 37

The Board has announced that it will publish the ED amending IAS 37, 'Provisions, contingent liabilities and contingent assets', before the end of December. The new measurement guidance is likely to result in entities' liabilities being larger and more numerous.

Management should start to collect the data that it will need to assess the liabilities on this new basis now. If the amounts are materially different from those currently included in the entity's balance sheet, management should consider how this will be disclosed.

The Board expects to publish the final standard mid-2010, following a three-month comment period.

The February edition of *IFRS news* will publish PwC's guidance on the proposals.

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Proposed IFRS 1 amendment provides limited exemption from comparative IFRS 7 disclosures for first-time adopters

What is the issue?

Existing IFRS preparers were granted relief from presenting comparative information for the new disclosures required by the March 2009 amendments to IFRS 7, 'Financial instruments: Disclosures'. The relief was provided because the amendments to IFRS 7 were issued after the comparative periods had ended. The use of hindsight would have been required to prepare the disclosures. The Board has therefore permitted entities to exclude comparative disclosures in the first year of application. Certain first-time adopters (first reporting period starting before 1 January 2010) would otherwise be required to present the comparative information, as first-time adopters do not use the transition provisions in other IFRSs. The Board has therefore proposed an amendment to IFRS 1 to provide first-time

adopters with the same transition provisions (and thereby the same relief) as included in the amendment to IFRS 7.

Who is affected?

A first-time adopter may apply the disclosure relief offered under the amendment if its first IFRS reporting period starts earlier than 1 January 2010. The proposed amendment will be effective for annual periods beginning on or after 1 July 2010; early application is permitted.

The proposed amendment has a 30-day comment period, with comments due to the Board by 29 December 2009. The Board expects to finalise the amendment at its January 2010 meeting.

IFRIC 19 clarifies the accounting for 'debt for equity swaps'

What is the issue?

IFRIC 19, 'Extinguishing financial liabilities with equity instruments', was published last month, clarifying the accounting when an entity renegotiates the terms of its debt with the result that the liability is extinguished by the debtor issuing its own equity instruments to the creditor (referred to as a 'debt for equity swap').

Before IFRIC 19, some recognised the equity instrument at the carrying amount of the financial liability and did not recognise any gain or loss in profit or loss; others recognised the equity instruments at the fair value of equity instruments issued and recognised any difference between that amount and the carrying amount of the financial liability in profit or loss. This diversity in the accounting for such transactions has become more pervasive in the current economic environment.

IFRIC 19 requires a gain or loss to be recognised in profit or loss when a liability is settled through the issuance of the entity's own equity instruments. The amount of the gain or loss recognised in profit or loss will be the difference between the carrying value of the financial liability and the fair value of the equity instruments issued. The fair value of the existing financial liability is used to measure the gain or loss if the fair value of the equity instruments cannot be reliably measured.

Entities will no longer be permitted to reclassify the carrying value of the existing financial liability into equity (with no gain or loss being recognised in profit or loss). The amount of the gain or loss should be separately disclosed on the face of the statement of comprehensive income or in the notes.

Who is affected?

All entities that enter into debt-for-equity swap transactions (in full or partial settlement of a financial liability) are affected by IFRIC 19. It does not impact the investor's accounting. It also does not change the guidance for convertible bonds where extinguishing the liability by issuing equity shares is in accordance with its original terms. IFRIC 19 does not apply to transactions with shareholders or to most transactions between entities under common control.

What should management do?

IFRIC 19 applies for annual periods beginning on or after 1 July 2010; for calendar year-end entities, this means the 2011 financial statements. Earlier application is permitted. It should be applied retrospectively from the beginning of the earliest comparative period presented, as application to earlier periods would result only in a reclassification of amounts within equity. Entities undertaking such debt-for-equity swaps should understand this interpretation's requirements.

Amendment to IFRIC 14**What is the issue?**

The IASB last month issued an amendment to IFRIC 14, 'IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction'. It removes an unintended consequence of IFRIC 14 related to voluntary pension prepayments when there is a minimum funding requirement.

Who is affected?

The amendment to IFRIC 14, 'Prepayments of a minimum funding requirement', will have a limited impact. It applies only to companies that:

- have a defined benefit pension plan that is subject to a minimum funding requirement under local legislation: and
- have prepaid (or expect to prepay) the minimum funding requirement in respect of future employee service, leading to a pension surplus.

Some companies that are subject to a minimum funding requirement have elected to prepay their pension contributions. The prepaid contributions are recovered through lower minimum funding requirements in future years. The previous version of

IFRIC 14 did not permit the recognition of an asset for any surplus arising from the voluntary prepayment of minimum funding contributions in respect of future service. This was an unintended consequence of the interpretation, which has been amended to require that an asset is recognised in these circumstances. Entities that have elected to prepay contributions and have until now restricted the asset recognised for any surplus in accordance with IFRIC 14 will be affected. These entities should reconsider their accounting to determine whether an asset for the prepaid contributions should be recognised. Entities that plan to prepay minimum funding contributions from which the employer can benefit by reduced contributions in future periods will also be affected.

When does the amendment apply?

The amendment is effective for annual periods beginning on or after 1 January 2011 and will apply from the beginning of the earliest comparative period presented. Early adoption is permitted. The impact should be assessed as early as possible to determine whether the amendment should be adopted before the effective date.

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- Versioned standards
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PRICEWATERHOUSECOOPERS 

'Twas the night before Christmas...IFRS style

'Twas the night before Christmas, when all through the town
No accountants were stirring, they'd all gone to ground.
IFRS 9 was despatched to Brussels with hope,
Fast track status, the answer was 'nope'.

The bankers were nestled all snug in their beds,
While visions of bonuses danced in their heads.
The board members scurried to get it all done,
Just one more ED, then off to the sun.

When out on Cannon Street there arose such a clatter,
They sprang from their desks to see what was the matter.
Away to the window they flew like a flash,
Faster than IFRIC 19, they threw up the sash.

The moon on the breast of the new-fallen snow
Gave the lustre of midday to objects below.
When, what to their wondering eyes should appear,
But a big black cab pulled by eight monster reindeer.

With a little old driver, so lively and brave,
They knew in a moment it must be St Dave.
More rapid than eagles his coursers they came,
And he whistled, and shouted, and called them by name!

"Now Impairment! Now, Hedging! Now, Equity and Debt!
On, Consol! On, JVs! On Leasing and Rev Rec!
To the top of the porch! To the top of the wall!
Now dash away! Dash away! Dash away all!"

As deferred taxes that before the wild hurricane fly,
When they meet with an obstacle, mount to the sky.
So up to the roof top the coursers they flew,
With the sleigh full of goodies, and St Dave too.
And then, in a twinkling, they heard on the roof

The prancing and pawing of each monster hoof.
They were shaking their heads and turning around,
Down the chimney St Dave came with a bound.
He was dressed all in red, from his head to his foot,
And his clothes were all tarnished with ashes and soot.
A bundle of standards he had flung on his back,
And he looked like a pedlar, just opening his pack.

The board members had all hung their stockings with care
Hoping for new standards, did they dare?
The IFRIC were seeking interpretations galore,
Or improvements at least to even the score.

The board members were seeking a gift beyond price,
A principle based standard, with language precise,
A basis for conclusions that stood proud and tall,
Loved by regulators, preparers, analysts and all.
The IFRIC weren't looking for something that clear
Confusion and muddle to create doubt and fear
The staff hung their heads and then clenched their teeth,
No more new standards, they want some relief

St Dave spoke not a word, but went straight to his work,
And filled all the stockings, then turned with a jerk.
And laying his finger aside of his nose,
And giving a nod, up the chimney he rose!

He sprang to his taxi, to his team gave a whistle,
And away they all flew like the down of a thistle.
But I heard him exclaim, ere he drove out of sight,
"Happy Christmas to all, and to all a good-night!"

Adaptation by Mary Dolson. See the next issue of *IFRS news* to see what they found in their Christmas stockings.

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