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global excellence in audit, tax & consulting

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Issue 7

RSM Reporting

Welcome from the Editor
Marco Mongiello

Welcome to the seventh edition of RSM Reporting - the newsletter from RSM International covering technical developments in global accounting and reporting.

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In our continuous attempt to respond to and anticipate the feedback of our readers, who are highly appreciative of our contributors' opinions and experience, this edition introduces an enhanced format. The section 'News and Updates' has been removed to give more space for the section 'The point of view of…'. Factual information about the most topical events relevant to accounting and reporting is nevertheless included in 'Accounting and reporting this quarter'.

The contents of this edition are characterised by a number of IASB and FASB ongoing projects that have been debated among users and preparers for quite a while that approached, or came to, a conclusion at the end of last year.

In particular, our guest contributor, Professor Chris Chapman, shares with us his very critical view about the departure from the indirect method of reporting the cash flow statement and its forward-looking merits.

'Forward-looking' is also the main rationale for the management commentary, as Joseph Ellul Falzon observes, resuming his contribution on this matter's developments (see Issue 3) since the publication of the standard at the end of last year.

In the same last few days of 2010 the long and tortuous journey of the amendments to IAS 12 seems to have reached an end point, as commented by Simon Fisher who, too, resumes his contribution on this matter (see Issue 1).

Chandra Sekaran reports on the Exposure Draft on Hedge Accounting and shares his opinion about the potential dangers and difficulties of its application, touching upon a topic whose companion, fair value measurement, is addressed by Joelle Moughanni in her Top Ten Topics page. This, too, links to a previous contribution on IFRS 9 (see Issue 5).

I hope you enjoy reading this edition. Please refer to the editorial team if you would like to take part in current debates or would like to draw our attention to new topics.

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1 Accounting and reporting this quarter

IASC/IASB

» go to www.ifrs.org to follow up any of the following news

IASC/IASB

December 2010

The IASB has published an IFRS Practice Statement on Management Commentary, as a broad, non-binding framework for the presentation of narrative reporting to accompany financial statements prepared in accordance with IFRSs. More on this matter is in the following pages.

The IASB published, for public comment, an Exposure Draft (ED) on the Accounting for Hedging Activities. The ED proposes requirements that will enable companies to better reflect their risk management activities in their financial statements, and, in turn, help investors to understand the effect of those activities on future cash flows.

January 2011

The IASB has published for public comment 'Financial Instruments: Impairment'. This is a supplementary document to the ED Financial Instruments: Amortised Cost and Impairment. The supplementary document is a joint document published by the IASB and the FASB. The scope of the document is open portfolios of financial assets measured at amortised cost, excluding short-term trade receivables.

The IASB published for public comment an ED on Offsetting Financial Assets and Financial Liabilities. The FASB will be publishing an identical ED.

Under current accounting requirements, the circumstances when financial assets and financial liabilities may be presented on an entity's balance sheet as a single net amount, or as two gross amounts, differs depending on whether the entity reports using IFRSs or US GAAP. The accounting differences result in the single largest quantitative difference in reported numbers in balance sheets prepared in accordance with IFRSs and US GAAP.

This reduces the comparability of these balance sheets, and is especially prominent in the presentation of derivative assets and derivative liabilities by financial institutions.

February 2011

On revenue recognition, the IASB and FASB tentatively decided that:

- An entity should recognise an asset for the incremental costs of obtaining a contract that the entity expects to recover. Incremental costs of obtaining a contract are costs that the entity would not have incurred if the contract had not been obtained.
- An asset recognised for the costs of obtaining a contract should be presented separately in the statement of financial position and be subsequently amortised on a systematic basis consistent with the entity's performance under the contract(s) to which the asset relates.

EFRAG

» go to www.efrag.org to follow up any of the following news

EFRAG

December 2010

EFRAG has concerns about certain aspects of the proposals in the ED Insurance Contracts. In particular, it believed that the IASB has not sufficiently considered the interaction with IFRS 9, the questions that constitute the performance of an insurer and the presentation of performance in the financial statements of an insurer. Other concerns relate to the subsequent measurement of the residual margin, the summarised margin presentation on the face of the statement of comprehensive income and the transition requirements.

EFRAG has concerns about certain aspects of the proposals in the ED Leases. In particular, EFRAG believes that the boundary between leases and service contracts is difficult to determine and supports a single partial derecognition model for lessors. The other main concern relates to the inclusion in the measurement of lease assets and liabilities, of amounts payable under options to extend the lease and contingent rental agreements.

January 2011

EFRAG agrees with the direction of the proposals in the ED Hedge Accounting. However, EFRAG also has a number of concerns. EFRAG believes that:

- The IASB will need to consider the various phases of the IAS 39 replacement as a whole before finalising the resulting standards.
- A number of issues require further consideration because they could create an inconsistency with risk management practices.
- The proposals rely heavily on judgement and the link to risk management and field-tests and outreach activities should be conducted to ensure that proposals are operational.
- The IASB should not finalise a standard on the general hedge accounting model, before developing a model for macro hedging.

February 2011

EFRAG urges the IASB to consider the proposals in the ED Offsetting Financial Assets and Financial Liabilities in the context of the existing disclosure requirements in IFRS 7 Financial Instruments: Disclosures, taking into account the disclosure proposals made in other consultation documents in respect of accounting for financial instruments. This is needed to ensure that the level of guidance included in the disclosure standard remains consistent and balanced across topics.

2 The point of view of ... Guest Contributor

Professor Chris Chapman

......on The direct and indirect method of reporting the Cash Flow

(interviewed by the Editor, Marco Mongiello)

Most of the time, when I bump into Chris Chapman on campus, we have the opportunity to exchange some reflections on topical matters in accounting and reporting. The latest of our conversations spurred from the ongoing FASB/IASB project on financial statement presentation. In particular, there currently seems to be some debate on the merits and pitfalls of the proposed direct method of presenting the Cash Flow Statement. It is commonly agreed that the focus of the users of accounts, who aim at performing a firm's valuation, is on its free cash flow. However, it pertains to a more technical domain that the free cash flow, as calculated from the Cash Flow Statement is imprecise and gives a biased view of the firm's cash performance.

Indeed, the free cash flow from operations must result from a reclassification of the Cash Flow Statement, whereby the operational cash inflow and cash outflows must be separated from the financing flows. The latter can be hidden among operating activities in the forms of, for example, liquidation of marketable securities or delays in payments to trade creditors which, in substance, are financial activities. Equally, proceeds from, or investments in, financial assets appear together under cash from investment and will have to be separated from those that refer to operating assets.

So, it all comes down to the question of what method of presentation of the Cash Flow Statement allows an easier reclassification exercise for the purpose of finding out the free cash flow from operations.

I know how sceptical Chris is about the introduction of the direct method. Hence, I like to provoke him stating that there is little difference, between direct and indirect methods, if you focus on the free cash flow. This is his reaction:

"Well, my primary interests are management accounting so I guess I tend to focus on specific decisions that people may make with specific kinds of information. The thing that most puzzles me about the direct method, as yet, is that whereas I felt I understood how users might specifically use indirect method cash flow figures to inform a company valuation, I am not so clear how the direct method supports this. The reason I liked the indirect method is that it gave an easy way to distinguish between flows and stocks.

You have operating activities, i.e. you take your profit figure, which is the starting assumption about what the next year's cash flow will be. You adjust that for non-cash items above that line such as depreciation and general provisions. Then based on what you think is happening to the economy, to the market, to the strategy fit of the company, you adjust that forecast figure up or down.

The indirect method then offered me an easy way to separate out the effects of operating cash flow of movements in working capital. Those affect the cash, but in a one-off way, because you cannot consistently keep reducing your stock or increasing it. Whilst I can see that figures such as payments to suppliers are closer to the general ledger format (and so maybe easier to prepare) I don't see how you separate out the one-offs from the flows you reasonably expect to continue.

Let me take one line item: cash from customers. Say that the cash has gone up this year. I do not know if this is a sustainable increase because you have actually increased the level of sales activity or because you have been tighter in your working capital policy and have extended less credit. This has two very different forward looking implications. If the level of activity has increased, as a working assumption this amount of cash flow will better represent what future cash flow will be. Whilst, if the increase is due to having tightened the credit policy, this is not sustainable; next year it will go back down to the base level of activity. Again, in the forward looking remit the movement of working capital that was separated out was valuable information to help differentiate what is a good estimate of future cash flow and what is a one-off adjustment for this year.

To sum up, I understood what decision the user was trying to make and how the data was formatted to support the analysis of that problem under the indirect method. What I don't yet understand with direct cash flow figures is how you use them since they seem to muddle up ongoing activities with movements in stocks. Paragraph 14 of the IASB/FASB working paper seems to emphasise that this kind of decision making support is appreciated, with the strong resistance from analysts to the elimination of the reconciliation under any circumstances.

The discussion document offers an interesting insight into the benefits perceived from the direct method, which are heavily based on auditability, precision and speed of preparation. The guidance that the disaggregation of cash flows should be "meaningful" is a good one, however, what I didn't get from the document was a clear sense of what the decision benefits of the new format were. There is an inevitable trade off between relevance and reliability, is this about a swing towards the latter?"

This is indeed an interesting point of view, particularly for our readership of preparers, auditors and users. In fact, it appears from the discussion, which has accompanied the proposal of the direct method, that sight might have been lost of the main principle of accounting, i.e. reporting should focus on the informational needs of "current and potential investors, creditors and other users in their capacity of providers of capital".

In fact, most of the theoretical support for the direct method fails to convince. One of the most authoritative sources on financial accounting and reporting, Elliott and Elliott, do not seem to find much more to say in favour of the direct method other than that it "appears to be a genuine format for a cash flow statement, whereas the indirect method is a cross between a cash flow statement and a funds flow statement" and that "the principal advantage of the direct method is that it shows operating cash receipts and payments"[2]. However, for the purpose of projecting future cash flows, it is exactly those operating cash receipts and payments that must be adjusted.

Hence, it appears that the main argument that still stands in favour of the direct method is that it is perhaps easier to report and audit according to the general ledgers of the accounts.

Format of the Cash Flow Statement according to the indirect method:

Cash Flow Statement for the month ended 31 January 2011

Operating Activities	
Net Income	$ 7,000
Plus depreciation expense	1,000
Less gain on sale of stock	(500)
Less increase in accounts receivable	(10,000)
Less increase in inventory	(5,000)
Plus increase in accounts payable	20,000
Plus increase in interest payable	500
Cash flow from operating activities	$ 13,000
Investing Activities	
Purchase of equipment	$ (60,000)
Purchase of securities	(3,000)
Sale of securities	3,500
Cash flow from investing activities	$ (59,500)
Financing Activities	
Issuance of stock	$ 200,000
Increase in notes payable	50,000
Repurchase of treasury stock	(100)
Cash flow from financing activities	$ 249,900
Total cash flow	$ 203,400
Beginning cash	0
Ending cash	$ 203,400

Format of the Cash Flow Statement according to the direct method:

Cash Flow Statement for the month ended 31 January 2011

Operating Activities	
Cash collected from customers	$ 20,000
Cash paid for rent	(2,000)
Cash paid to employees	(3,000)
Cash paid for utilities	(2,000)
Cash flow from operating activities	$ 13,000
Investing Activities	
Purchase of equipment	$ 60,000
Purchase of securities	(3,000)
Sale of securities	3,500
Cash flow from investing activities	$ (59,500)
Financing Activities	
Issuance of stock	$ 200,000
Increase in notes payable	50,000
Repurchase of treasury stock	(100)
Cash flow from financing activities	$ 249,900
Total cash flow	$ 203,400
Beginning cash	0
Ending cash	$ 203,400

source: www.financial-education.com

Guest Contributor: Professor Chris Chapman

Chris Chapman is Professor of Management Accounting at Imperial College Business School. He is Editor in Chief of Accounting, Organizations and Society.

Chris sits on the editorial boards of Journal of Management Accounting Research, Management Accounting Research and Asia-Pacific Management Accounting Journal, and was previously a member of the editorial board of Contemporary Accounting Research.

Chris is also a member of the managing board of the European Institute for Advanced Studies in Management and chairs the Institute's Programme Development Group. The Handbook of Management Accounting Research which Chris co-edited was awarded the Management Accounting Section of the American Accounting Association 2008 Notable Contribution to Management Accounting Literature Award.

[2] Elliott and Elliott, Financial Accounting and Reporting, 2011, ch. 26

2 The point of view of ...

Joseph Ellul Falzon

...on Management commentary – Practice statement

On 8 December 2010, the IASB delivered an early Christmas present to the financial community, in the shape of an IFRS Practice Statement on Management Commentary. A first (and perhaps last) of its kind, the Practice Statement sets out a non-mandatory framework to guide the presentation of management commentary, its stated objective being to assist management in presenting useful management commentary relating to financial statements prepared in accordance with IFRSs. It consequently aims at enhancing the usefulness of the information provided in the entity's management commentary so that, when this is provided together with the financial statements, users would be able to make better informed decisions about providing resources to the entity.

The issuing of this Practice Statement was no spur of the moment decision, representing the final act of a project that began in the closing months of 2002. At that time, a team comprising representatives of the national standard-setters in the United Kingdom, Germany and New Zealand, and of the Canadian Institute of Chartered Accountants, was set up by the IASB to examine the potential for issuing a standard or guidance on management commentary. The results of the project team's work were published in a Discussion Paper on 27 October 2005, and following significant discussion an Exposure Draft on the subject matter was issued on 23 June 2009. After receiving 103 comment letters, most of which were supportive of the project, the Practice Statement was finally issued eight years from its inception, and an entity may apply it to management commentary presented prospectively from 8 December 2010.

The Practice Statement is prepared on the basis that management commentary meets the definition of "other financial reporting" as defined in paragraph 7 of the Preface to International Financial Reporting Standards, which states that "....other financial reporting comprises information provided outside financial statements that assists in the interpretation of a complete set of financial statements or improves users' ability to make efficient economic decisions....". Consequently, management commentary lies within the scope of the Conceptual Framework for Financial Reporting and should be read in the context of that framework.

However, the Practice Statement is not an IFRS and entities applying IFRSs will not be required to comply with the Practice Statement, unless required to do so by their particular jurisdiction. In turn, non-compliance with the Practice Statement will not prevent an entity that prepares its financial statements in accordance with IFRSs from making the explicit and unreserved statement of such compliance as required by IAS 1.

Nonetheless, the Practice Statement does state that when management commentary is presented, management should explain "the extent to which the Practice Statement has been followed", and furthermore, in a similar fashion to IAS 1, that "an assertion that management commentary complies with the Practice Statement can be made only if it complies with the Statement in its entirety".

In view of this, and to avoid confusion to users of financial reports, the Practice Statement mandates the clear identification of what constitutes management commentary, as distinct from other information that may be presented in the financial reports that, while being useful, would not form part of management commentary. Furthermore, the related financial statements are to be made available with, or otherwise identified in, the commentary being presented.

In determining what information to include in its commentary, management should consider the needs of existing and potential investors, lenders and other creditors, being the primary users of financial reports. Commentary should provide users of financial statements with integrated information that provides a context for the related financial statements, and should therefore be consistent with the principles of providing management's view of the entity's performance, position and progress, and of supplementing and complementing information that is presented in the related financial statements.

To align with these principles, the commentary should include forward-looking information and information that is understandable, relevant, reliable and comparable – the four qualitative characteristics described in the Conceptual Framework. The necessity for commentary to possess these characteristics should result in the avoidance of situations whereby information is presented on a selective basis in an attempt, deliberate or otherwise, to influence the user towards a predetermined judgement or decision. The strictest adherence to these characteristics should go a long way in assuring the user that the information provided in the commentary is shorn of bias, and hence reliable.

That is why, in my opinion, the contemplation of these characteristics in the Practice Statement is of crucial importance. It is, if you will, the 'safety clause' in the Statement, providing comfort to the user that the information provided by way of commentary is, within the parameters of the uncertainties it is presented, management's fairest assessment of the entity's historical performance, situation and its cash flows, and of its future prospects.

Ultimately, users of financial reports require information that will help them assess the performance of the entity and the actions of its management relative to their stated strategies and future plans. Management commentary should therefore provide management's viewpoint on the entity's performance, position and progress to enable users to understand, among other things, the entity's risk exposures and management's response to such risks, and the possible effect of non-financial factors and resources that are not presented in the financial statements on the entity's operations and its published results.

Management commentary should also be forward-looking, detailing management's perceived objectives and its strategies for meeting those objectives. Furthermore, when management becomes aware of trends, uncertainties or other factors that could affect the entity, it should provide information about the extent to which the entity's performance, liquidity and financial position may be expected to change in the future, and why, and should include an assessment of the entity's prospects in the light of current period results. Management should also explain how and why the entity's performance during the current period compares to the expectations presented in the prior period management commentary.

Forward-looking information may be presented through narrative explanation or quantified data and accompanied by a description of the assumptions used in providing the information, but management is not specifically required to include projections or forecasts.

The Practice Statement mandates that management commentary should be clear and straightforward, consistent with its related financial statements, and devoid of generic disclosures and unnecessary duplication of disclosures already made in the financial statements, unless accompanied by further analysis that adds further value to the user. The Statement acknowledges that since the nature of every business, the regulatory environment in which they operate, and the strategies adopted by management are different for each entity, then the form and content of the commentary must also necessarily be different. However, management commentary should include information that is essential to an understanding of the nature of the business, management's objectives and its strategies for meeting those objectives, the entity's most significant resources, risks and relationships, the results of operations and prospects, and the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

It seems to me, that such information is not substantively different - if you'll excuse the pun - from information normally required by an entity's auditors. Auditors use this information not only to assist them in planning their audit, but also as corroborative evidence that lends further credence to amounts and disclosures in the financial statements. I would expect users of financial reports to digest management commentary in a similar fashion.

It will now be interesting to see how many entities will take up the option of presenting commentary in a manner consistent with this Statement, and, perhaps more importantly, to assess users' perception of whether or not the information presented actually enhances the usefulness of the financial statements, and if so, to what extent.

As in most everything else in life, time will be our greatest teacher in this regard.

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2 The point of view of ...

Simon Fisher

...on The update on IAS 12 - Income Taxes

In my article in Issue 1 of *RSM Reporting* in December 2009, I discussed the long awaited Exposure Draft (ED) on Income Tax, issued in March 2009, which was expected to replace IAS 12 – Income Taxes. The journey to reach this point had been long and tortuous, with the IASB discussing the need to converge IAS 12 with US GAAP (SFAS 109) since 2003 (see following page). At one stage it looked as though the IASB would come up with something even more complex than the already reviled IAS 12, with talk of deferred tax being computed using simultaneous equations, but in the end they took a more pragmatic approach. Their main objective was to do away with the 'initial recognition exemption' of IAS 12. However, the draft also included the proposal that the tax base of an asset should always be determined using the assumption that the carrying amount of the asset would be recovered by sale (rather than reflecting the manner in which the entity expects to recover the carrying amount of the asset – through sale or through use). The IASB also tackled a number of other issues including those relating to investments in foreign entities such as subsidiaries and associates, and tax arising on distribution of profits.

That ED was, however, received negatively by the majority of those submitting comments, particularly in the key areas mentioned above. As I observed in my previous article, it had included a number of 'pragmatic compromises' in an attempt to achieve convergence with US GAAP that were not necessarily based on sound principles. In their meeting in November 2009, the IASB decided to abandon the ED and instead attempt to address a limited number of specific issues. This was confirmed in their March 2010 meeting when they agreed that their objective would be to resolve problems in practice without changing the fundamental approach under IAS 12, and preferably without increasing divergence from US GAAP. The IASB had earlier indicated that they would defer undertaking a fundamental review of accounting for income taxes, jointly with FASB, until sometime in the future.

It was most unfortunate that before the IASB took the decision to abandon the ED it was used as the base for redrafting the chapter on Income Taxes in the IFRS for SMEs, which was then issued without further exposure. So SMEs will have to live with the changes at least until 2013, which is the earliest date on which the IFRS for SMEs can be amended. SMEs, who were amongst the strongest critics of IAS 12 as being too complicated, are now saying 'give us back IAS 12 – it was a good standard'. However strong one's dislike of IAS 12, one has to acknowledge that the writers of IAS 12 understood their subject and knew what they wanted, even if principles had to be compromised with one or two arbitrary rules (such as the initial recognition exception). Whilst initially difficult to understand and apply, people were finding that with sufficient guidance, training and experience of application, IAS 12 worked.

By July 2010, the IASB had agreed that the revised scope of their project should include:

- Deferred tax on investment property measured at fair value.
- Uncertain tax positions, but only after finalisation of amendments to IAS 37, Provisions, Contingent Liabilities and Contingent Assets.
- Certain proposals in the earlier ED that had received general support from respondents.

This was followed by the issue of a new ED, Deferred Tax: Recovery of Underlying Assets in September 2010. By this time the IASB had expanded the proposal to include not only investment property measured at fair value, but also property, plant and equipment and intangible assets measured using the revaluation model under IAS 16 and IAS 38 respectively. The essence of the ED was that deferred tax assets and liabilities related to such assets should be measured by applying the rebuttable assumption that the carrying amount of the asset will be recovered entirely by sale. The argument put forward to support this was that the expected manner of recovery of such assets was difficult and subjective to determine.

Comments by a number of respondents, including RSM International whose comment letter was sent to the IASB on 9 November 2010, were along the lines of:

- For assets that are depreciated under IAS 16 or amortised under IAS 38, it does not make sense to suggest that determining the expected manner of recovery is difficult and subjective when those assets are, by definition, held for use and are already being depreciated down to their residual values over their estimated useful lives.
- There is no justification for applying a different method of measuring deferred tax for (a) assets that have been revalued and (b) similar assets carried at amortised cost.

The IASB recognised these views when issuing the final version of Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) on 20 December 2010 and reverted to restricting the changes to investment property measured at fair value only. The amendments therefore introduce the presumption that the carrying value of an investment property carried at fair value is recovered entirely through sale. The presumption also applies when measuring deferred tax relating to an investment property acquired in a business combination if the acquirer will use the fair value model when subsequently measuring that investment property. The presumption is rebutted if the investment property is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale. The interpretations within SIC 21, which dealt with recovery of revalued non-depreciable assets, have been incorporated in the amendments to IAS 12 insofar as they did not relate to investment property carried at fair value, and SIC 21 has been withdrawn. The amendments take effect for annual periods beginning on or after 1 January 2012, with earlier application permitted, and have to be applied retrospectively.

The impact of adopting the amendments will in many cases result in a reduction in deferred tax liabilities relating to investment properties carried at fair value, since capital gains tax rates (applying on recovery through sale) are generally lower than income tax rates (applying on recovery through use). In the lucky few countries where there is no capital gains tax, the reduction could be significant. The reduction could be yet more significant in the case of investment properties acquired as part of a business combination. For such properties, the 'initial recognition exemption' would not have applied, and deferred tax could have been measured on the entire carrying amount of the property at income tax rates if the tax base was zero (which is quite common for investment property).

In the Basis for Conclusions the IASB has pointed out that in some cases it might be necessary to rework the calculation of goodwill for a past business combination on initial retrospective application of the amendments, and practical difficulties might be encountered if the combination took place some time ago.

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Some essential facts about the convergence between IFRSs and US GAAP

Memorandum of Understanding (MoU)

"The IASB and the US Financial Accounting Standards Board (FASB) have been working together since 2002 to achieve [...] a common set of high quality global standards [...]."

2002 - Norwalk Agreement of September

The IASB and the FASB agree to work together, in consultation with other national and regional bodies, to remove the differences between international standards and US GAAP. The first document issued was the MoU.

2006 - A roadmap for convergence 2006 – 2008

The boards further strengthen their commitment by setting specific milestones to be reached by 2008.

2007 – Relaxation of rules on reconciliation.

The US Securities and Exchange Commission (SEC) removes the requirement for non-US companies registered in the United States to reconcile their financial reports with US GAAP if their accounts complied with IFRSs as issued by the IASB. At the same time, the SEC also publishes a proposed roadmap on adoption of IFRSs for domestic US companies.

2008 - Updated version of the Memorandum of Understanding

The two boards issue an update to the MoU, which identifies a series of priorities and milestones to complete the remaining major joint projects by 2011. More emphasis is put on producing common, principle-based standards.

2009 – G20

The convergence process gains momentum and responds to specific requests of the G20 by publishing a progress report describing an intensification of their work programme. This includes the hosting of monthly joint board meetings and providing quarterly updates on their progress on convergence projects.

2010 - New sets of priorities

The volume of draft standards escalates hence the IASB and the FASB must separate the projects for which the need for improvement of IFRSs and US GAAP is the most urgent (June 2011 is retained as target date to complete them) from those which have a relatively lower priority and for which a later completion date would be appropriate.

(source: www.IASB.org)

2 The point of view of ...

...Chandra Sekaran

...on IFRS 9 – a follow up

As part of the third phase of the International Accounting Standards Board's project to replace IAS 39 Financial Instruments: Recognition and Measurement, an Exposure Draft (ED) on hedge accounting was published on 9 December 2010 for public comment. The ED does not include consideration of open portfolios or macro hedge accounting which the IASB will continue to discuss. The ED is open for comment until 9 March 2011. The IASB intends to finalise these proposals during the first half of 2011. The ED proposes significant changes in hedge accounting and if the proposals in the ED are confirmed, there would be a better one-to-one matching of hedge accounting with risk management. The key changes proposed in this ED are discussed below.

The objective of hedge accounting is to reflect in the financial statements the effect of an entity's risk management activities that use financial instruments to manage exposures arising from particular risks that could affect the income statement.

The ED proposes that non-derivative financial asset and non-derivative financial liability are measured at fair value through profit or loss and may be eligible for designation as a hedging instrument. Under IAS 39, at present a non-derivative financial asset or non-derivative financial liability may be designated as a hedging instrument only for a hedge of foreign currency risk.

The Board proposes to eliminate 80-125% for testing whether a hedging relationship qualifies for hedge accounting and recommends meeting the objective of the hedge effectiveness assessment to ensure that the hedging relationship will produce an unbiased result and minimise expected hedge ineffectiveness. The IASB wants to eliminate 80-125% hedge effectiveness testing since this basis is more in line with a rule based approached whereas IFRS is a principle-based standard. In my view, it needs to be seen in practice since only entities which have a clear policy and structure for risk management would be able to comply with this.

The exposure draft proposes the accounting for fair value hedges similar to cash flow hedge accounting. As per the proposal, the gain or loss on the hedging instrument and hedged item should be recognised in other comprehensive income. The ineffective portion of gain or loss shall be transferred to profit or loss. Under the current IAS 39, the gain or loss on the hedging instrument and the hedged item for fair value hedge, is accounted in profit or loss. As per the exposure draft, the accounting is the same for all types of hedges such as cash flow hedge, fair value hedge and hedge of a net investment in foreign operation. In my opinion, although this achieves consistency in hedge accounting, the nature and type of risk being hedged are different for cash flow hedge, fair value hedge and hedge of a net investment in foreign operation.

The ED is suggesting that the time value premium of a purchased option be treated as a cost of hedging that will be presented in other comprehensive income. In IAS 39, the undesignated time value of an option is treated as held for trading and is accounted for at fair value through profit or loss. The time value of a purchased option reflects the cost of obtaining a one-sided protection that protects an entity against the downside risk while giving participation on the upside. The time value of the option reflects in substance the probability that the entity will make use of its right to the downside protection.

The Board decided not to propose an alternative accounting treatment to account for hedges of credit risk using credit derivatives.

The ED is recommending that the eligibility criteria for hedges of group of items should be the same as individual hedged items. However, certain restrictions are kept for cash flow hedges of net positions for which the offsetting risk positions affect profit or loss in different reporting periods.

The ED proposes that an entity may designate as the hedged item certain risk components, provided that risk component is separately identifiable and reliably measurable. This is irrespective of whether the risk component is a financial or non-financial item. IAS 39 allows components of financial items to be hedged but not components of non-financial items. Risk managers often hedge a risk component for non-financial items, for instance, the oil price component of the jet fuel price exposure.

IAS 39 does not allow net positions to be hedged. The ED proposes extending the use of hedge accounting to net positions and thereby improving the link to risk management.

In response to feedback from investors, the ED proposes a comprehensive set of new disclosures that focus on the risks being hedged, how those risks are being managed, and the effect of hedging those risks upon the primary financial statements.

The ED proposes that a combination of an exposure and a derivative may be designated as a hedged item.

The ED proposes that an entity shall discontinue hedge accounting when the hedging relationship ceases to meet the qualifying criteria. An entity should discontinue hedge accounting when it no longer reflects the risk management strategy. This is again a very judgmental and subjective area wherein only large entities with a clear vision and policy for risk management would be able to comply with this proposed amendment.

The ED proposes that a layer component of the nominal amount of an item should be eligible for designation as a hedged item with the exception of a contract that includes a prepayment option in fair value hedge if the option's fair value is affected by the changes in the hedged risk.

An entity should be required to rebalance the hedging relationship when it fails to meet the objective of the hedge effectiveness assessment but the risk management objective for the hedging relationship remains the same. In practice, it needs to be seen how this would be implemented since the Board is now expecting all entities to have a closer link with risk management objectives and procedures.

The ED proposes that amounts that are reclassified from other comprehensive income to profit or loss should be presented in a separate line item in the income statement for cash flow hedges of a net position.

The Board proposes to amend the scope of IAS 39 to allow a commodity contract to be accounted for as a derivative in appropriate circumstances. [note from the Editor: For example, contracts to buy or sell non-financial items are inside the scope of the ED if net settlement occurs, i.e. when either counterparty is permitted to settle net, or the non-financial assets is readily convertible in cash, or there is relevant past practice.]

In conclusion, it appears that the ED proposes significant changes. Therefore, I welcome its proposal that hedge accounting be applied prospectively as one of pragmatism.

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Some essential facts on IFRS 9

The IASB aims to replace all of the requirements of IAS 39 by the second quarter of 2011.

Phase 1: Classification and measurement

IFRS 9 Financial Instruments was published in November 2009 and contained requirements for financial assets. Requirements for financial liabilities were added to IFRS 9 in October 2010. Most of the requirements for financial liabilities were carried forward unchanged from IAS 39. However, some changes were made to the fair value option for financial liabilities to address the issue of own credit risk.

Phase 2: Impairment methodology

The exposure draft Amortised Cost and Impairment was published in November 2009 with a comment deadline of 30 June 2010.

Phase 3: Hedge accounting

The exposure draft Hedge Accounting was published in December 2010 with a comment deadline of 9 March 2011.

Offsetting financial assets and liabilities

The IASB will also address offsetting of financial assets and liabilities. The boards have decided to issue jointly a separate exposure draft proposing changes to address differences in their standards on balance sheet netting of derivative contracts and other financial instruments that can result in material differences in financial reporting by financial institutions.

(source: www.IASB.org)

3 Top Ten Topics in IFRS

Joelle Moughanni

Fair Value Measurement

This article provides the background of the IASB's fair value measurement project and explains how the IASB plans to finalise an IFRS on fair value measurement. Almost on the eve of the publication of the IFRS on fair value measurement, this overview is a first step towards a better and in-depth understanding of the forthcoming provisions and their practical implications for the financial statements' preparers, analysts, auditors and other users.

1. What is the background to the IASB's Fair Value Measurement (FVM) project?

The FVM project is included in the Memorandum of Understanding between the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) that sets out a roadmap towards convergence of IFRSs and US GAAP. Also, the progress on this project was an important milestone in the IASB's response to the global financial crisis.

The result of the IASB's discussions with the FASB will be an International Financial Reporting Standard (IFRS) on fair value measurement that is almost the same as US amended Topic 820. The forthcoming IFRS would apply when other IFRSs require or permit fair value measurements or disclosures. In other words, the IFRS would specify how (and not when) an entity should measure fair value and disclose fair value information.

2. What are the timeline and milestones of the IASB's Fair Value Measurement project?

- Discussion Paper - In November 2006, the IASB issued their preliminary views for public comment.
- Exposure Draft - On 28 May 2009, the IASB published for public comment ED/2009/5. In developing the guidance contained in the ED, the IASB's starting point was the US SFAS 157 (now Topic 820).

On 29 June 2010, in response to comments received, the IASB issued a limited re-exposure (ED/2010/7) of a specific issue relating to the measurement uncertainty analysis disclosure (in order to reflect the interdependencies between unobservable inputs used to measure fair value in Level 3, see Q&A 8).

Importantly, the ED reflects the experience gained from the financial crisis.

- IFRS - Based on the most recent IASB project timetable, the final standard on fair value measurement is now expected in the first quarter of 2011. The effective date and any transitional provisions are still to be determined.
- Educational Material - In the second quarter of 2011, the IFRS is expected to be accompanied by some educational material that will describe, at a high level, the thought process for measuring assets, liabilities and an entity's own equity instruments at fair value.

3. What are the main objectives of the IASB's Fair Value Measurement project?

The ultimate objectives of the IASB with this project are to determine the following whilst also not losing sight of convergence with US GAAP:

- *Establish a single source of guidance for all fair value measurements* - Current guidance on measuring fair value is distributed across many IFRSs and is not always consistent since it has been added piecemeal over the years. Also, current guidance is often incomplete, thus introducing complexity and diversity in practice.
- *Clarify the definition of fair value and related guidance* - The existing definition of fair value is confusing in some respects (e.g. it does not specify whether a market participant's point of view is as a buyer or seller). More details in Q&A 6.
- *Enhance disclosures about fair value measurements* - Increased transparency about fair value measurements would benefit users of financial statements, particularly when assessing the fair value measurements of assets and liabilities without active markets (e.g. valuation techniques and inputs used to measure fair value). This need for additional guidance for measuring fair value in inactive markets has been even further highlighted by the financial crisis.

4. Is this Fair Value Measurement project a means of expanding the use of fair value in financial reporting under IFRSs?

No, this is definitely not the next step towards full fair value accounting under IFRSs as some thought. As addressed above (Q&A 3), the project aims only at developing a framework for measuring fair value; it neither introduces nor requires any new fair value measurements.

The proposed guidance deals with how fair value should be measured when it is required or permitted by existing standards; it does not extend the use of fair value in any way. It does not introduce new fair value measurements, nor does it eliminate existing practicability exceptions to fair value measurements (e.g. the exception in IAS 41 Agriculture when an entity is unable to measure reliably the fair value of a biological asset on initial recognition).

In other words, the forthcoming IFRS will not specify when, but how an entity should measure an asset, a liability or its own equity instruments at fair value.

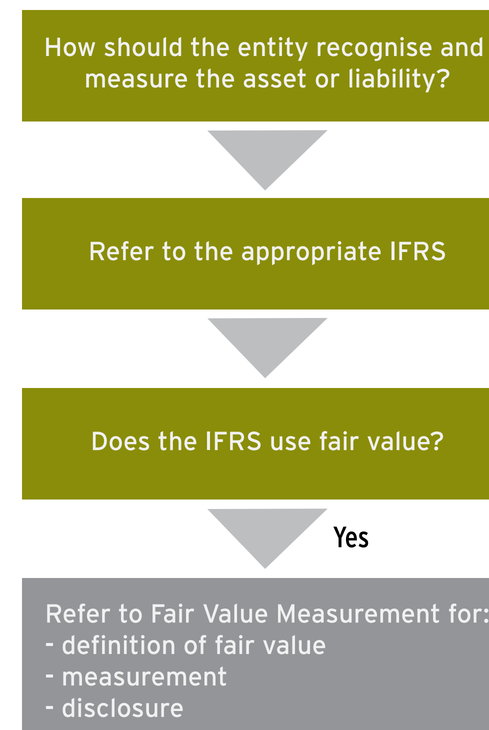
5. How does the future standard relate to other IFRSs?

The forthcoming IFRS will define fair value, provide guidance on how to measure fair value and will set the disclosure requirements relating to fair value measurements.

Top Ten Topics

1. Impairment ✓
2. Fair value measurement ✓
3. Derecognition of financial instruments and Consolidation of Special Purpose Entities ✓
4. Purchase price allocation and Intangible assets ✓
5. Debt vs. Equity ✓
6. Hedging
7. Deferred tax
8. Revenue recognition
9. Employee benefits
10. First-time adoption of IFRS ✓

As illustrated below, the proposed standard will apply only when an existing IFRS already requires or allows an asset or liability to be measured at fair value. Fair value measurement guidance applies to all assets and liabilities measured at fair value (i.e. both to financial instruments and to non-financial assets and liabilities).



6. What is the proposed definition of fair value and how does it compare to the existing one?

In replacement of the current definition of fair value (the amount for which an asset could be exchanged, a liability settled, or an equity instrument granted, between knowledgeable, willing parties in an arm's length transaction), the fair value measurement framework will be based on a core principle that defines fair value as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date".

The main features of this new definition are the following:

- *Exit price* - Fair value is an estimate of the price to sell an asset or to transfer a liability. It is not the price to buy the asset or to incur the liability (entry price).[3]
- *Market participant perspective* - Fair value is a market-based measurement, not an entity-specific measurement. Therefore, a fair value measurement uses the assumptions market participants would use when pricing the asset or liability, including assumptions about risk. A fair value measurement must not reflect a reporting entity's business model or intentions; it is market-based and is the same regardless of who owns the asset or owes the liability. An exit price of an asset or liability embodies expectations about the future cash inflows and outflows associated with the asset or liability from the perspective of market participants at the measurement date. This is regardless of whether an entity intends to use an asset or to sell it to fulfil the liability over time or to transfer it to another party. A direct implication of this market participant perspective is the probable prohibition by the forthcoming IFRS of applying blockage factors.
- *Orderly transaction* - This is a transaction that assumes exposure to the market for a period before the measurement date to allow for marketing activities that are usual and customary for transactions involving such assets or liabilities. In an orderly transaction, both the buyer and the seller are willing, but not required, to transact. In fact, an exit price definition of fair value does not imply a liquidation value where the seller is compelled to enter into a transaction (a forced transaction or distressed sale).
- *Timing of transaction* - The transaction to sell an asset or to transfer a liability occurs at the measurement date, taking into account market conditions and expectations at that date.

The current definition of fair value for assets simply refers to an arm's length exchange between knowledgeable, willing parties, without specifying whether the exchange is to buy or to sell the asset.

The current definition of fair value for liabilities refers to a settlement between knowledgeable, willing parties, without specifying who the 'knowledgeable, willing parties' are and whether the settlement occurs by fulfilling the obligation directly with the counterparty or indirectly by transferring it to a third party.

Also, the current definition does not indicate when the exchange or settlement takes place.

Consequently, the proposed new definition describes more precisely what fair value means in order to improve consistency in application.

Cont'd >

[3] The IASB concluded that a current entry price and a current exit price will be equal when they relate to the same asset or liability on the same date in the same form in the same market. In many cases, a difference between an entry price and an exit price is related to a difference in the unit of account for the entry and exit transactions. The unit of account issue is beyond the scope of the fair value measurement project and should be determined in accordance with the appropriate IFRS.

3 Top Ten Topics in IFRS

7. How should the fair value of a liability be measured in the many cases where there is no observable market to transfer the liability?

In such situations, an entity should estimate the amount at which a liability could be transferred in a transaction between market participants by using the same thought process that would be used to measure the fair value of the liability held by another entity as an asset (i.e. the fair value of the corresponding asset that reflects its highest and best use that is physically possible, legally permissible and financially feasible). Actually, if the liability is traded as an asset, the observed price also represents the fair value of the issuer's liability.

If there is no corresponding asset (e.g. for a decommissioning liability assumed in a business combination), the fair value of the liability could be measured using a valuation technique, such as the present value of the future cash outflows that market participants would expect to incur in fulfilling the obligation.

The fair value of a liability reflects non-performance risk, which is the risk that an entity will not fulfil an obligation, presumed to be the same before and after the transfer. Non-performance includes an entity's own credit risk. However, a restriction on an entity's ability to transfer its liability to another party does not affect the fair value of the liability because the fair value of a liability is a function of the requirement to fulfil the obligation and the effect of a restriction is already reflected in the price.

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Note 11 – Own credit (extract - to be continued)

When valuing financial liabilities recorded at fair value, the Group takes into account the effect of its own credit standing. The categories of financial liabilities on which own credit spread adjustments are made are issued debt held at fair value, including issued structured notes, and derivatives. An own credit adjustment is applied to positions where it is believed that counterparties would consider the Group's creditworthiness when pricing trades.

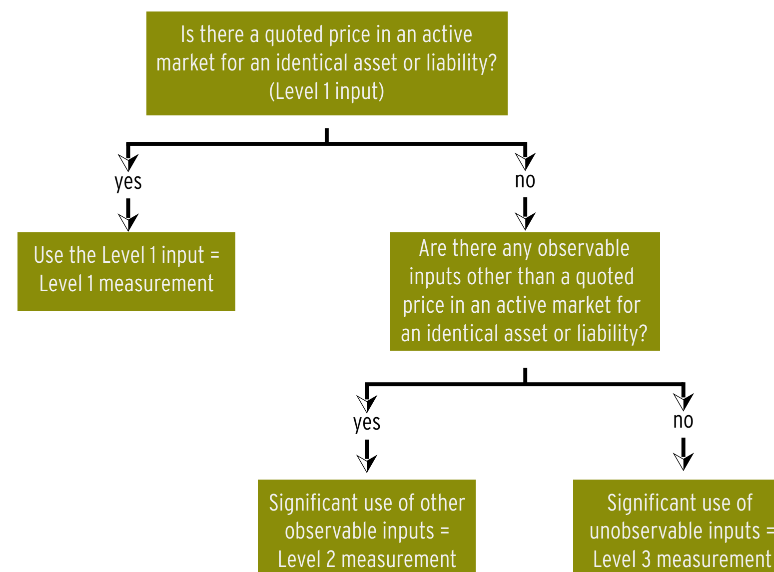
For issued debt and structured notes, this adjustment is based on independent quotes from market participants for the debt issuance spreads above average inter-bank rates, (at a range of tenors) which the market would demand when purchasing new senior or sub-debt issuances from the Group. Where necessary, these quotes are interpolated using a curve shape derived from CDS prices.

8. What is the "Fair Value Hierarchy"?

In its Exposure Draft, the IASB proposes a three-level fair value hierarchy that categorises observable and non-observable market data used as inputs for fair value measurements:

- *Level 1 inputs* - Highest priority to unadjusted quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date.
- *Level 2 inputs* - These are either directly (i.e. as prices) or indirectly (i.e. derived from prices such as interest and exchange rates) observable inputs other than quoted prices included within Level 1.
- *Level 3 inputs* - These are inputs for the asset or liability that are not based on observable market data. Such unobservable inputs must reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

This is summarised in the decision tree below. Obviously, non-financial items would have more Level 3 fair value measurements.



9. The definition and determination of fair value refers to "market", but which market is it?

A fair value measurement assumes that the transaction to sell an asset or to transfer a liability takes place in the principal market for the asset or liability (i.e. the market with the greatest volume and level of activity for the asset or liability) or, in the absence of a principal market, the most advantageous market for the asset or liability. This principal market is considered to provide the most representative input for a fair value measurement because it is the most liquid market for the asset or liability. Also, there is a presumption that the principal market is the market in which an entity normally enters into a transaction for the asset or liability.

10. How might an entity construct a hypothetical transaction when little or no market information exists with which to measure fair value?

For some assets and liabilities, there are no observable market transactions and market information might not be available. However, the measurement objective remains the same: an exit price from the perspective of a market participant that holds the asset or owes the liability.

The exit price for an asset in a market that is not active is the price that would be received in a transaction with a market participant that would hold that asset. In such situations, an entity might have no alternative but to use unobservable inputs (Level 3 of the proposed fair value hierarchy). Although such information might include an entity's own data, the entity cannot ignore information about market participant assumptions that is reasonably available.

When markets are not active (e.g. for some intangible assets acquired in a business combination) or are no longer active (e.g. for some financial instruments as a result of the recent financial crisis), measuring fair value depends on the facts and circumstances and requires the use of significant judgement. An entity will have to determine whether transactions in that market are not orderly (see Q&A 6). If the evidence indicates that a transaction is not orderly, an entity places little, if any, weight on that transaction price when measuring fair value or estimating market risk premiums. If the evidence indicates that a transaction is orderly, an entity considers that transaction price when measuring fair value or estimating market risk premiums. The amount of weight placed on that transaction price when compared with other indicators of fair value will depend on the facts and circumstances such as the size of the transaction, the comparability of the transaction to the asset or liability being measured and the proximity of the transaction to the measurement date.

The following note, extracted from RBS Group Annual Report and Accounts 2009, is enlightening of the amount of details that should be disclosed in order for such valuation techniques to make sense to the users and to be considered valid and reliable.

Note 11 - Valuation techniques for financial instruments carried at fair value (extract - continued)

The Group uses a number of methodologies to determine the fair values of financial instruments for which observable prices in active markets for identical instruments are not available. These techniques include: relative value methodologies based on observable prices for similar instruments; present value approaches where future cash flows from the asset or liability are estimated and then discounted using a risk-adjusted interest rate; option pricing models (such as Black-Scholes or binomial option pricing models) and simulation models such as Monte-Carlo.

The principal inputs to these valuation techniques are listed below. Values between and beyond available data points are obtained by interpolation and extrapolation. When utilising valuation techniques, the fair value can be significantly affected by the choice of valuation model and by underlying assumptions concerning factors such as the amounts and timing of cash flows, discount rates and credit risk.

[Specific valuation techniques are given below for each of the following: Bond prices, Credit spreads, Interest rates, Foreign currency exchange rates, Equity and equity index prices, Commodity prices, Price volatilities and correlations, Prepayment rates, Counterparty credit spreads, Recovery rates/loss given default.]

In order to determine a reliable fair value, where appropriate, management applies valuation adjustments to the pricing information gathered from the above sources. These adjustments reflect the Group's assessment of factors that market participants would consider in setting a price, to the extent that these factors are not reflected in that pricing information. Furthermore, on an ongoing basis, the Group assesses the appropriateness of any model used. To the extent that the price provided by internal models does not represent the fair value of the instrument, for instance, in highly stressed market conditions, the Group makes adjustments to the model valuation to calibrate to other available pricing sources. Where unobservable inputs are used, the Group may determine a range of possible valuations derived from differing stress scenarios to determine the sensitivity associated with the valuation.

When establishing the fair value of a financial instrument using a valuation technique, the Group considers certain adjustments to the modelled price which market participants would make when pricing that instrument. Such adjustments include the credit quality of the counterparty and adjustments to compensate for any known model limitations.

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