

# IFRS News

Shedding light on the IASB's activities\*

Issue 27  
February 2005

## In this issue...

- 1 Issue of the month**  
IFRIC delivers its first interpretations
- 3 Foreign private issuers**  
Key issues facing US-listed FPIs in 2005
- 5 Interview**  
GCRG's Kevin Klein on current financial instruments hot topics
- 6 Contacts**

## Issue of the month

# IFRIC delivers first interpretations

The International Financial Reporting Interpretations Committee (IFRIC) published six interpretations and four draft interpretations in the second half of 2004. They are the results of the first two years of deliberation. IFRS News looks at the latest developments.

IFRIC was set up in March 2002 to provide guidance on financial reporting issues that are not addressed specifically in IFRS and to consider areas where conflicting interpretations may arise. Preparers have waited two years to receive the benefits of the Committee's work. They can expect a steady stream of interpretations over the next year now that IFRIC has its processes up and running.

The process for issuing interpretations is heavily consultative. IFRIC works with its national counterparts, sponsored by the national standard-setters, to reach conclusions on interpretations where there is consensus from national standard-setters and IFRIC members that an issue needs interpreting.

In May 2004, IFRIC released its first interpretation – IFRIC 1, Changes in Existing Decommissioning, Restoration and Similar Liabilities. There followed a six-month wait for IFRIC 2, Members' Shares in Co-operative Entities, released in November. More interpretations followed in December:

- IFRIC 3, Emission Rights;
- IFRIC 4, Determining whether an Arrangement Contains a Lease;
- IFRIC 5, Rights to Interests arising from Decommissioning, Restoration and Environment Rehabilitation Funds; and
- Amendment to SIC-12.

2004 also saw the release of a further four draft interpretations:

- D5, Applying IAS 29 – Financial Reporting in Hyperinflationary Economies for the First Time (final interpretation due in Quarter 2);
- D9, Employee Benefit Plans with Promised Return on Contributions or Promised Contributions (final interpretation due in Quarter 1);
- D10, Liabilities arising from Electrical and Electronic Equipment (final interpretation due 'late 2005').
- D11, Changes in Contributions to Employee Share Purchase Plans (final interpretation due in Quarter 3 or 4).

D6, Multi-employer Plans, was abandoned, as amendments have since been made to IAS 19. IFRIC will review at a later date the issues relating to the consideration of state plans, which formed part of D6.

An exposure draft on Service Concessions is due out this month, following lengthy discussions. We consider below the key provisions of some of the final interpretations.

### IFRIC 1

IFRIC 1 requires all changes of decommissioning liabilities arising from the change in the cash flows required to settle the obligation, or a change in the discount rate, to be accounted for prospectively.

#### Measurement – cost model

The change in the obligation adjusts the carrying value of the related asset. If the decrease in liability exceeds the carrying amount of the asset, the excess is recognised immediately in profit and loss (ie, no negative asset balances). If the adjustment increases the value of the asset, it may be an indication of impairment.

#### Measurement – revaluation model

A decrease in the obligation adjusts the revaluation surplus in equity. Any increase in the decommissioning obligation reduces the valuation surplus until it reaches zero. Any remaining increase in the liability is recorded immediately in the income statement.

The interpretation also amends IFRS 1, allowing an exemption for first-time adopters from reconstructing all past changes in decommissioning liabilities. The liability can be calculated at the date of transition to IFRS, with the corresponding debit included as part of the cost of the asset.

Companies that also report under US GAAP will have a continuing difference. SFAS 143, Accounting for Asset Retirement Obligations, does not require the decommissioning obligation to reflect the changes in the discount rate. Reductions in the decommissioning

liability are also treated differently.

IFRIC 1 is applicable for periods beginning on or after 1 September 2004, with earlier application encouraged.

### IFRIC 2

Members' shares in co-operative entities have some characteristics of equity. They also give the holder the right to redeem for cash or another financial instrument. The right to redeem may be subject to limits and conditions. IFRIC 2 provides guidance on how those redemption terms are evaluated in determining whether the financial instrument is debt or equity.

The scope of IFRIC 2 is not limited to shares issued by co-operative entities. The interpretation applies to any financial instrument within the scope of IAS 32, except instruments that will or may be settled in the entity's own equity instruments.

The key message of IFRIC 2 is that financial instruments should be classified as equity if the holders do not have a right to request redemption. This is the case if either of the two following conditions is met:

- The entity has an unconditional right to refuse redemption of the shares; or
- Local law, regulation or the entity's governing charter imposes an unconditional prohibition on the redemption of shares.

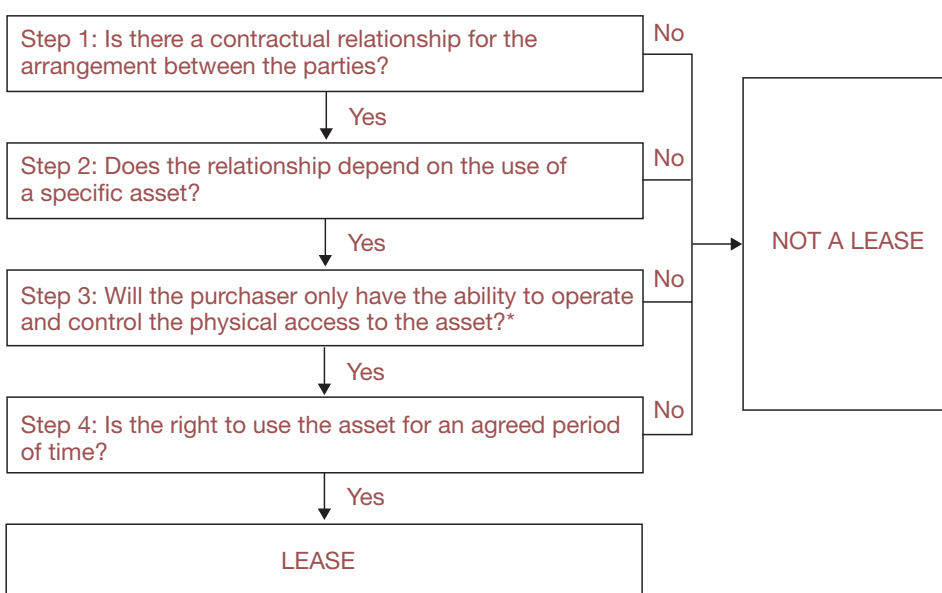
Provisions that prohibit redemption only if conditions, such as liquidity constraints, are met (or are not met) do not result in shares being equity. Illustrative examples are included in the appendix to IFRS 2.

The effective date and transition requirements are the same as those for IAS 32: an entity should apply this interpretation retrospectively for periods beginning on or after 1 January 2005. Earlier application is permitted.

### IFRIC 3

This interpretation sets out how a participant in an emission rights scheme should account for allowances bought or received free of charge from a government or government agency. An allowance gives the holder the right to produce a specified type of emission (for example, carbon dioxide) up to a certain level. Participants in the scheme can either use the allowances to pay for emissions made or sell them on to other parties. Participants can purchase additional allowances from other parties where emissions exceed the allowances held. The interpretation does not address the accounting to be adopted by market-makers in emission rights trading who would apply IAS 39 to account for their positions.

The March edition of IFRS News will look at IFRS 3 in greater detail.



\* The facts and circumstances of the arrangement should indicate that it is remote that one or more parties than the purchaser will take more than an insignificant amount of output.

**IFRIC 4**

IFRIC 4 provides guidance for determining whether transactions that do not take the legal form of a lease are in fact leases. Many long-term power purchase agreements or tolling contracts result in a single customer securing a majority of the capacity of a power plant or other facility.

The four-step approach required by the interpretation is as set out in the flowchart on page 2.

The assessment should be made at the inception of the arrangement and reassessed only under certain circumstances (for example, a change in the contractual terms, unless the change only renews or extends the arrangement).

Payments under the arrangement should be separated between lease payments (accounted for in accordance with IAS 17) and other elements (accounted for in accordance with other IFRSs).

The effective date of this interpretation is 1 January 2006; earlier application is permitted. Retrospective application is not required.

## Foreign private investors



## Key issues for FPIs in 2005

**PwC partner in the US Wayne Carnall is the leader of the firm's International Consultation and Review Group, which provides technical support and review of filings and offerings made by foreign companies in the US market. He talks to IFRS News about some of the issues facing US-listed foreign private issuers (FPIs) that are making the transition to IFRS.**

**Reconciliation errors**

Foreign private issuers are making a significant effort to embed IFRS into their reporting processes. Some are spending more time on this than they have in developing US GAAP information in the past. The process of embedding IFRS into their reporting process has resulted in the discovery of errors in the US GAAP information.

The following example illustrates a situation that we have seen several times in the last year. Evaluation of the accounting in a particular area will lead preparers to conclude that financial reporting under IFRS is different from what has been done in the past under home-country GAAP. However, there has never been a reconciling adjustment between home-country GAAP and US GAAP for this item – ie, US GAAP balances were not correct. In this situation, management would need to correct the US GAAP information – as a correction of an error – that will need to be mentioned in the auditor's report. The company would also need to consider a number of factors with respect to the correction of an error, including disclosures about weaknesses in internal controls. It would not be appropriate to delay correcting the US GAAP information until the company adopts IFRS in 2005.

**Differing interpretations of IFRS**

Another area that will be challenging for both the company and its auditors is what I refer to as 'regulatory harmonisation'. Regulators in different countries will interpret IFRS differently. In some cases, one regulator may interpret the standard more narrowly than another. For example, the SEC staff has indicated that it would not normally expect there to be a difference between IFRS and US GAAP for the determination of recognising a loss on a security for any other than temporary decline in value. This surprised many people, as the guidance in the US – which consists of the accounting standard issued by the FASB, a Staff Accounting Bulletin issued by the staff of the SEC, and several published SEC enforcement cases – is far more extensive than the guidance contained in IAS 39. However, the SEC staff believes that the guidance is conceptually the same and therefore should yield comparable results.

Even more problematic are situations in which the regulators will take conflicting views. In one situation, the SEC required a classification of an expense in a certain manner in an initial registration statement in the US, while the regulator in Europe required classification of expense in a different manner. As a result, in the offering document in the US, the

company presented an operating loss in its financial statements prepared in accordance with IFRS, while in their European offering document issued on the same day, they presented operating income in their IFRS financial statements. Both offering documents made reference to the other offering document that contained different information. This situation is not good for the investing public.

The SEC and CESR have entered into an agreement to work together and share information. While such actions are good and important in addressing broad policy issues, it will not normally facilitate the resolution of issues in which regulators have a different view on the interpretation of a particular IFRS issue. These matters confront companies and their accountants on a frequent basis and need to be resolved in a short time period. The enhancement of informal communications between the regulators, and with the IASB, as appropriate, will benefit companies, their advisers and most importantly investors, as there will be more consistent application of IFRS globally.

**The devil is in the detail**

Even as the FASB and the IASB try to harmonise the standards – at least on a conceptual basis – there will be

differences in the details of the application of the standard. Such differences, while perhaps small in nature, can have a material effect on the financial statements. Standards that are conceptually consistent will not necessarily produce results that are comparable. The devil is in the detail of the application of the standard.

Take as an example the accounting for income taxes. FAS 109 and IAS 12 are conceptually similar, but there are a number of differences in the specific application. One of those differences is that SFAS 109 does not allow a deferred asset or liability to be recognised for differences relating to assets and liabilities that are remeasured from the home-country currency into the functional currency and that result from changes in exchange rates and indexing for tax purposes. IFRS does not have a similar exception. While this may be viewed as a technical difference in the standards, it does not mean that the difference will be inconsequential. In fact, for one company, the deferred tax asset was US\$20 billion greater under IFRS compared to US GAAP as a result of this provision.

### IAS 39 carve-out

The SEC has proposed to eliminate the requirement to provide the third year of audited financial statements for companies that are adopting IFRS for the first time. As proposed, this accommodation would be limited to companies that completely adopt IFRS, ie, companies using the IAS 39 carve-out won't be eligible for this accommodation. It is expected that this will be an issue primarily for the companies in the financial services sector.

The SEC staff has not officially commented on the applicability of the accommodation for companies that follow the IAS 39 carve-out. However, this did not stop the EC from issuing written guidance stipulating that companies using the IAS 39 carve-out would be entitled to the accommodation. Companies should not assume that the EC's view will prevail. I expect the SEC to adopt the proposed rule in the next few months and that the adopting release will address the

applicability of the accommodation of companies adopting the carve-out provisions of IAS 39.

The consequences of the issue are greater than just presenting one more year of financial statements. As a result of the application of IFRS 1, if the starting point changes from 2004 to 2003, this will impact a number of measurement issues in 2004 and the years in the future.

### Early disclosure of IFRS – impact

A number of companies that will be adopting IFRS in 2005 are presenting 2004 income statements prepared using IFRSs that are expected to be in force at the end of December 2005. This information is being made public, and in some instances there is an auditor's report on this information. While discussions about the implications in the US among the accounting firms and the

US standards and IFRSs that are conceptually consistent will not necessarily produce comparable results. The devil is in the detail.

SEC staff continue, these companies will be expected to reconcile this information to the historical financial statements once issued. If the changes are due to the misapplication of the standard, the company may need to present this as a correction of an error and address all of the related implications – for example, reporting on internal controls, officer certifications, etc.

Companies that are going to present IFRS information for 2004 before reporting in 2005 are strongly encouraged to prepare a reconciliation of that information to US GAAP to ensure that the presentation of the IFRS amounts are not inconsistent with the views/conclusions that are being presented regarding US GAAP.

Companies should discuss with their auditors and legal counsel the information about 2004 before publishing so they can evaluate the implications of presenting that information.

### SEC challenges to primary financial statements

While the SEC staff will challenge the accounting followed in the primary financial statements, historically the majority of the challenges by the SEC and the restatements were related to US GAAP information. Once IFRS is adopted, there is a greater chance that the SEC staff will question, challenge and require restatement of the accounting followed in the primary financial statements. Restatements of the primary financial statements will have greater implications than changes to US GAAP reconciliations, including greater litigation risk.

The SEC's chief accountant says the staff will scrutinise the first year of IFRS financial statements closely. I would not assume this applies just for the first year.

I predict a large number of US GAAP restatements in 2005 and 2006 as part of IFRS embedding process discussed above. In the two to three years after that, I expect that there will be a number of companies that will be required to restate their primary financial statements as many new issues under IFRS are addressed and resolved.

On the long road towards harmonisation, the change to IFRS in 2005 is a major event that will benefit investors globally. Before the benefits can be reaped, companies need to pay careful attention to the transition to minimise the bumps on the road.

*Wayne Carnall is the leader of PwC's International Consultation and Review Group. He is the primary person representing both clients and the firm before the SEC on matters relating to non-US companies. He is responsible for establishing and publishing the firm's guidance on matters relating to US GAAP, US GAAS and SEC reporting matters for non-US companies. Wayne worked for the SEC between 1991 and 1997, first as staff accountant, then associated chief accountant, deputy chief accountant and as associate director of accounting operations and member of the Senior Executive Service of the US Government.*



## Teamwork in financial instruments

**Kevin Klein is a director in PwC's Global Corporate Reporting Group (GCRG) and leader of GCRG's financial instruments team since joining in May 2004. He talks to IFRS News about his role and hot topics in his area.**

### What did you do before joining GCRG?

I was based in PwC's TICE Energy Group and provided technical and audit services to UK and US listed companies. My main focus was advising energy and utility companies on the application of IAS 39 to their operations. I worked with them to develop the best structures to apply to their commodity contracts to facilitate the achievement of their objectives.

I had a role in the development of PwC's global IFRS thought-leadership publication, 'Crunch Time' for the energy sector, leading the IAS 39 discussions. The application of IAS 39 is very complex for dynamic companies in this sector. IAS 39 creates significant income statement and balance sheet volatility for most of them, which represents a major change from national GAAP.

Joining GCRG has provided me with the opportunity to continue to share my energy expertise on a global basis and apply my IAS 39 skills to corporate treasury matters. My focus has broadened considerably since joining the group.

### What are the current financial instrument hot topics?

One of the critical issues is the hedging of intragroup forecasted transactions. The hedging designations utilised by existing preparers cannot be continued on adoption of IAS 39 revised. The IASB developed an exposure draft to deal with

this issue, but its approval is pending. It continues to be an area of uncertainty for IFRS preparers.

A significant amount of enquiries we receive relate to the compliance of hedging strategies with IAS 39. Many of the hedge designations we review qualify for hedge accounting. The guidance in the standard is very proscriptive, and hedge accounting remains a privilege versus a right. We also receive questions on the determination of an entity's functional currencies and treatment of quasi-equity loans as companies finalise their transition to IFRS.

### What are your plans for the FI team going forward?

We will continue to expand this year to meet the growing need for financial instrument advice. The team consists of 12 specialists, including three partners. We are looking to have more interaction with national technical teams and develop closer relationships with those that routinely consult with us. The financial instruments team has been organised by topic and industry specialism (see box on p6).

The firm's policy requires first-time adopters listed on a major exchange to be reviewed by the GCRG. The number of financial statement reviews to be completed this year has significantly increased. It is our goal to have regular dialogue with the national reviewers and engagement teams to facilitate efficient reviews, as well as to reduce the number of significant points arising during the reviews.

### What are the greatest challenges facing the GCRG currently, and you in particular?

The greatest challenge facing GCRG is to ensure consistent application of IFRS by PwC clients. Diverse industry practices existed under national GAAPs, and new, cohesive industry practices must develop for IFRS. Various industry groups within the firm and outside are tackling the key issues. It takes time to reach a consensus, and many companies transitioning to IFRS are slow to let go of past practices and take a 'clean sheet' approach.

My greatest challenge will be to manage the work-life balance of the team, while delivering timely advice. The level of growth in consultations and accounts review will continue to increase, especially those related to first-time adoption, and everyone needs an answer yesterday!

### How do you offset this onerous workload against spending time with your young family?

Work-life balance is very important to me. I have a nine-month-old son, and seeing him in the evening is a priority. I achieve work-life balance through starting work early in the morning. I usually manage to get a seat on the train (which is a challenge for most commuters to London), which enables me to make the best use of my commuting time. Effective use of time is my key to successful work-life balance!



## Applying IFRS – solutions for 2005

PwC's authoritative guidance on the application of International Financial Reporting Standards, 'Applying IFRS', has been updated to reflect the requirements of the standards that are mandatory for 2005. It provides solutions for the presentation of financial statements, assets, liabilities, reporting financial performance, revenue and expenses. It also includes background to IFRS standard-setting and general principles.

This continually updated e-publication connects to over 1,000 real-life solutions – industry-specific and general – with links to applicable text in the standards and interpretations. Find out more by visiting [www.pwc.com/ifrs](http://www.pwc.com/ifrs)

Financial instrument topic	Team member	Partner
Hedging	Kevin Klein, Jacques Zribi, Per Ove Zetterlund	Marc Minet
Securitisations	Jessica Gage	Jan Buisman
Derecognition	Jessica Gage, Tasos Nolas	Jan Buisman
Debt versus equity	Per Ove Zetterlund	Marc Minet
Embedded derivatives	Reto Zemp	Marc Minet
Effective interest rate	Jeanine Schembri	Marc Minet
Interest rate margin hedging	Jessica Gage	Pauline Wallace
Fair value	Cornelia Herzog	Pauline Wallace
Impairment	Jeanine Schembri	Pauline Wallace
IAS 21	Reto Zemp	Marc Minet
IFRS 4	Francesco Nagari	Pauline Wallace
<b>Industry specialism</b>		
Banking	Jessica Gage, Jeanine Schembri	Pauline Wallace
Corporate treasury	Kevin Klein, Jacques Zribi, Per Ove Zetterlund	Marc Minet
Energy	Kevin Klein, Per Ove Zetterlund	Pauline Wallace
Energy derivatives	Kevin Klein	Pauline Wallace
Insurance	Francesco Nagari, Jeanine Schembri	Pauline Wallace
Leasing	Tasos Nolas	Jan Buisman
Real estate	Tasos Nolas	Jan Buisman

## Contacts

### For further help please contact:

#### Head of the Global Corporate Reporting Group

Ian Wright: Tel: +44 207 804 3300; [ian.d.wright@uk.pwc.com](mailto:ian.d.wright@uk.pwc.com)

#### Business Combinations and Adoption of IFRS

Mary Dolson: Tel + 44 207 804 2930; [mary.dolson@uk.pwc.com](mailto:mary.dolson@uk.pwc.com)

Simon Wray: Tel +44 207 804 7705; [simon.wray@uk.pwc.com](mailto:simon.wray@uk.pwc.com)

Andrea Toselli: Tel +44 207 804 6086; [andrea.toselli@uk.pwc.com](mailto:andrea.toselli@uk.pwc.com)

Tony de Bell: Tel +44 207 213 5336 ; [tony.debell@uk.pwc.com](mailto:tony.debell@uk.pwc.com)

Caroline Woodward (Valuation issues): Tel: +44 207 804 7392; [caroline.woodward@uk.pwc.com](mailto:caroline.woodward@uk.pwc.com)

#### Financial Instruments and Financial Services

Pauline Wallace: +44 207 804 1293; [pauline.wallace@uk.pwc.com](mailto:pauline.wallace@uk.pwc.com)

Marc Minet: +44 207 804 1931; [marc.minet@uk.pwc.com](mailto:marc.minet@uk.pwc.com)

Jan Buisman (Leases): +44 20 7804 3977; [jan.buisman@uk.pwc.com](mailto:jan.buisman@uk.pwc.com)

Kevin Klein: +44 207 212 4028; [kevin.klein@uk.pwc.com](mailto:kevin.klein@uk.pwc.com)

#### Liabilities, Revenue Recognition, Provisions, Pensions, Deferred Tax, Share-based Payment

Rich Sharko: +44 207 804 2214; [rich.sharko@uk.pwc.com](mailto:rich.sharko@uk.pwc.com)

Matthieu Moussy: +44 207 804 5061; [matthieu.moussy@uk.pwc.com](mailto:matthieu.moussy@uk.pwc.com)

Richard Davis (Actuarial issues): +44 207 212 4565; [richard.davis@uk.pwc.com](mailto:richard.davis@uk.pwc.com)

#### IFRS News editor

Joanna Malvern: +44 207 804 9377; [joanna.c.malvern@uk.pwc.com](mailto:joanna.c.malvern@uk.pwc.com)