

IFRS News

Shedding light on the IASB's activities*

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Issue of the month

IAS 21 amendments

The IASB released changes last month to IAS 21, The Effects of Changes in Foreign Exchange Rates, as an amendment to the standard. The changes are effective for annual periods commencing on or after 1 January 2006. Early application is encouraged.

The changes relate to inter-company loans that fund foreign operations. They allow companies to better align treasury strategy and financial reporting and keep foreign exchange volatility on such loans funding foreign operations out of the income statement. They also reduce the potential differences with US GAAP.

The changes to IAS 21 include:

- a new paragraph 15A, which explains that the net investment definition in paragraph 15 includes loans between sister companies; and
- a change in the wording of paragraph 33, permitting inter-company loans denominated in any currency to be part of a net investment in a foreign operation. Such loans previously had to be denominated in the functional currency of one of the parties to the transaction.

The IASB did not adopt proposed changes to the wording in paragraph 15.

Transition

Most companies will welcome the amendments to IAS 21, but there are some nuances around how and when they should be applied for the first time. The position for entities that wish to adopt the amendments in 2005 is summarised in the diagram on the next page.

Interim financial statements for first-time adopters

First-time adopters in some jurisdictions were not required to prepare interim financial information that was IFRS-compliant. Interim financial information was often prepared on the basis of accounting policies consistent with those that management expected to be effective at year-end. Management was required to apply judgement as to whether an amended version of IAS 21 would be published and effective at year-end. This was uncertain at the time when entities released their interim financial information and the final wording of these amendments was unknown.

EU endorsement

The revision to IAS 21 made last month is in time for full IFRS preparers to apply the standard to their 2005 financial statements; it comes too late for EU endorsement before European companies release their 2005 results. This raises the question of whether entities reporting under EU-endorsed IFRS can apply the two amendments to IAS 21 for the year-end 2005 financial statements.

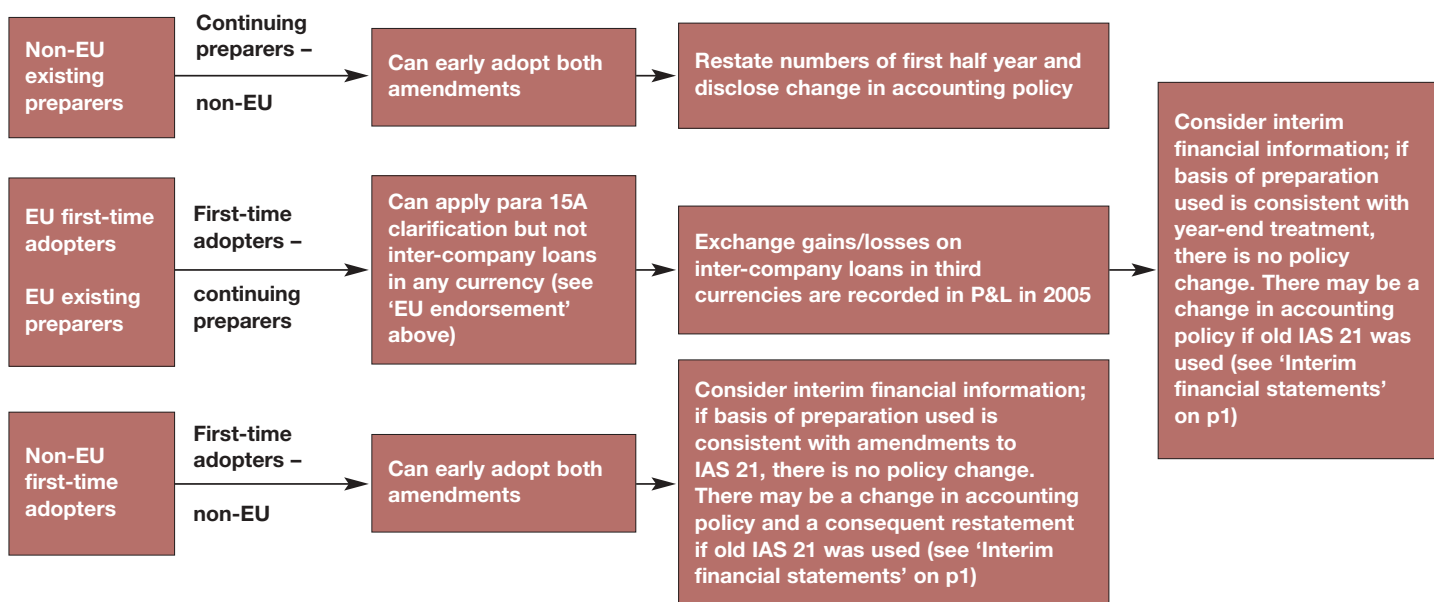
The revised guidance relating to loans between sister companies can be applied immediately by entities reporting under EU-endorsed IFRS. This guidance is limited to the introduction of an example (paragraph 15A). Paragraph 15 was not revised; the example simply clarifies the requirements of the standard.

The amendment relating to the currency of the inter-company loan must be endorsed by the EU before it can be

applied by EU reporters. Relaxing the previous restriction is a change in the standard from the current endorsed version of IAS 21.

Some preparers, particularly those with listings in the US, need to understand the impact of the views of the regulators on their particular circumstances. Consultation is strongly encouraged, and updates may be provided in future issues of *IFRS News* if the views of specific regulators become known.

Adopting amendments in 2005



Example of the accounting for the exchange difference during 2005

Accounting treatment for exchange differences arising in the consolidated financial statements on a sister-to-sister loan between two subsidiaries with different functional currencies. This occurs commonly in practice.

Entity A is an existing IFRS preparer. It applied the previous version of IAS 21 in 2004, IAS 21 (revised) for interim financial statements in 2005 and will early adopt the IAS 21 2005 amendments for year-end 2005.

B and C are subsidiaries of A. B (euro functional currency) has advanced a US dollar-denominated loan to C (US dollar functional currency). The loan is not expected to be settled in the foreseeable future and qualifies as quasi-equity.

B had a cumulative exchange gain of €5

million related to the loan deferred in equity at 1 January 2005. B recorded an exchange loss of €1.5 million in the first half of 2005 and an exchange gain of €1.0 million in the second half of 2005. The net exchange loss incurred in 2005 is therefore €0.5 million.

Entity A recorded the cumulative exchange gain of €5 million in a separate component of equity, called cumulative translation adjustment (CTA) in the 31 December 2004 consolidated financial statements (using the previous version of IAS 21). The CTA of €5 million was transferred to retained earnings on 1 January 2005, when the entity applied IAS 21 (revised).

The exchange loss of €1.5 million incurred in the six months ended 30 June 2005 is recognised in the consolidated income statement in accordance with IAS 21

(revised). The 2004 comparative information is restated, and the change in accounting policy is disclosed in accordance with IAS 8.

Entity A decides to early adopt the 2005 amendments to IAS 21 for the year ended 31 December 2005. The total cumulative exchange gains of €4.5 million (consisting of gains carried forward of €5 million and of losses for the year of €0.5 million) become the restated CTA. The CTA balance for the comparative period will be the same as under the previous version of IAS 21.

When A prepares its consolidated interim financial statements for the six months ended 30 June 2006, it will restate the comparative period ending 30 June 2005 and disclose the change in accounting policy in accordance with IAS 8.



Clear explanation of accounting policies, estimates and judgements for 2005

Preparers should provide comprehensive disclosure of accounting policies, judgements and sources of measurement uncertainty in their 2005 financial statements to enhance shareholder communication and reduce comments from regulators. Mary Dolson explains.

IAS 1 has some specific, bold-type requirements on disclosure of accounting policies and critical estimates and judgements (IAS1R.108 on accounting policies, IAS1R.113 on judgements and IAS1R.116 on sources of estimation uncertainty). Companies are required to make these disclosures but there is no 'tick list' of what matters should be covered. The first 'judgement' that management needs to make is what accounting policies should be disclosed and in how much detail, and what information should be given on potential uncertainty in estimates and critical judgements. This disclosure is important to effective communication with the users of financial statements, as well as compliance with IFRS.

2005 is a year of major change, when thousands of public companies are adopting IFRS and leaving national GAAP accounting policies behind for consolidated financial statements. Many companies will change accounting policies in a number of areas. Clear descriptions of revised accounting policies will be important for users to understand financial results under IFRS.

Financial reporting under a principles-based set of standards, in contrast to rules-based standards, probably requires more disclosure of accounting policies. Preparers may need to provide more detailed explanations of the policy choices and measurement bases they have used in preparing their financial statements.

Financial reporting with rules-based standards provides a form of short-hand communication between preparers and users of financial statements. The company can make a statement like: 'EITF 95-8 was followed in accounting for the contingent consideration related to the acquisition of Company X; as a result the entire amount will be charged as compensation expense over the vesting period of two years'. The same transaction under IFRS might require

more lengthy wording, explaining that the company considered the vesting provisions, market levels of compensation for the same roles and used valuation techniques, etc. The ability to refer to detailed rules provides users with a framework to understand how the company has accounted for specific transactions. The absence of rules will make it more difficult for readers to interpret broad or general statements within the accounting policies.

What can be achieved by more comprehensive disclosure of accounting policies (other than compliance)? Conveying good information that users expect to see and that answers obvious questions saves preparers from having to clarify matters for regulators and users, and allows management to focus communications on key business issues.

Accounting policies should focus on the areas most relevant to the business and the issues that those familiar to the industry would expect companies to disclose. If revenue recognition is known to be problematic within certain industries, analysts, regulators and other users will ask questions as to what certain numbers mean. A bland statement such as 'Revenue is recognised as it is earned' will not assist users in understanding how management has evaluated and applied the five key principles in IAS 18. Management should address obvious questions such as when the risks and rewards of ownership have transferred and how returns, discounts and rebates are calculated. The more information there is about how the principles have been applied, the more management's judgement can be understood.

A large multinational company, a leader in its industry and a continuing IFRS preparer, in its 2005 financial statements has provided detailed discussion of its accounting policies in areas critical to its

industry sector: 400 words on segment reporting, 500 words on pensions, other post-employment benefits and share-based compensation, 600 words on financial instruments, and over 700 words on acquisitions, all of these in the accounting policy section.

What are critical estimates that might give rise to measurement uncertainty and judgements? This can be a bit soul-searching for management; critical estimates and judgements are areas where management has had to make estimates for measurement purposes (including whether or not to book impairments) and the estimates a) require the application of judgement, and b) are most sensitive to changes in the assumptions used to arrive at an estimate. Contrast the two scenarios: a supermarket retailer would probably not describe its estimate of bad debts as a critical accounting estimate, as it is largely a cash or major credit card business. A broad-based consumer-lending business, however, might well choose describe its estimate of bad debts as a critical estimate. The consumer-lending business would respond to macro-economic factors, and there might well be different views on the economic outlook or the impact of specific factors on the loan portfolio.

Critical estimates and judgements are therefore specific to each company and its circumstances. However, another way to look at it is to understand that an estimate that is highly sensitive is a predictor of potential income statement volatility. The markets dislike surprises (good or bad); transparency can allow users better insight into today's results and those of future periods.

Good disclosure of accounting policies and critical estimates and judgements, particularly in this first year of broad application of IFRS, will help companies to inform users, avoid regulatory questions and comments and explain financial results.

IASB relaunches insurance contracts project – progress with Phase 2

Finding the way forward on insurance contract accounting has been a key objective for the IASB for some time. Phase 1 of the project, IFRS 4, Insurance Contracts, provides a short-term solution for first-time adoption of IFRS in 2005. IFRS 4 resolved a few insurance accounting issues, but left unresolved some accounting mismatches. It also did not remove the incompatibility with standards that existed prior to conversion to IFRS.

Phase 2 will tackle areas including the long-term nature of life contracts, the absence of a liquid market to assist fair value based valuation, and the multi-dimensional characteristics of contracts that can contain insurance, service, deposit and derivative elements.

The IASB started work on Phase 2 immediately after completing the stable platform. It established the Insurance Working Group (IWG) in August 2004, which includes insurance CFOs, financial

analysts, accountants and actuaries (including PwC's Sam Gutterman) to assess how various options might work in practice (see *IFRS News*, June 2005).

The main topics under discussion are:

- measurement models,
- up-front profit,
- unit-linked contracts,
- participating contracts,
- credit standing,
- renewals and cancellation rights,
- asset-liability management,
- acquisition costs,
- revenue recognition, and
- disclosure.

The IASB and IWG will continue to meet regularly this year and hope to issue a discussion paper by the

end of 2006. The Board expects that at least 18 months will be needed between the discussion paper and the exposure draft, with the final standard a year later. The IASB has urged industry and individual participants to contribute their thoughts early to ensure that the final solution is useful.



Sam Gutterman, PwC director and consulting actuary, and Francesco Nagari, director in the firm's global accounting consulting services, look at the direction of the debate and the challenges ahead in an article, 'The long road: Building a consensus on future insurance accounting', in the December 2005 edition of *Insurance Digest*. The PDF is available at:

www.pwc.com/insurance, and the hard copy from Alpa Patel: alpa.patel@uk.pwc.com

Interview



EC strategy on financial reporting: progress on convergence and consistency

European commissioner Charlie McCreevy spoke at the European Federation of Accountants (FEE) seminar in Brussels last month. Here are some highlights from his speech.

The EU is the largest jurisdiction making use of IFRS and we have a strong interest in moving forward towards worldwide standards. At the same time we must do our homework so that, inside the European Union, we will benefit fully from the standards which we adopt. This means, in the first place, ensuring that they are applied in a consistent manner. This is important not only for the success of IFRS as the set of global accounting standards, but also for our relationships with the US and Japan.

Consistent application of IFRS in the EU

There is no denying that consistent application of IFRS inside the EU is a challenge. Many players are involved and the standards are new, perhaps even, in certain respects, revolutionary. But I am determined to do my utmost to ensure that we will meet the challenge.

IFRS has the merit of being a principles-based standard, but 2005 is, of course, its first year of mandatory universal

application in Europe for about 8,000 EU-listed companies. It is reasonable to expect some teething problems in its application or interpretation to emerge and we need to address these effectively. Issuers will quite rightly seek guidance early on, when they are preparing their financial statements rather than later, after the regulator tells them they need to be restated. We must therefore be certain that suitable arrangements are in place to ensure that any emerging issues can be properly identified and resolved in time.

The Commission welcomes the efforts of the Committee of European Securities Regulators (CESR) to date. CESR has created several working groups in order to coordinate enforcement decisions in different jurisdictions. In the interest of transparency, there will also be a public database of such decisions taken in EU jurisdictions. But we also need some broader arrangements to facilitate consistent application at company level. Arrangements that bring together all the relevant stakeholders. This is why we have been looking at how we can achieve a smooth operating and efficient co-ordination mechanism, without any heavy procedures and new bureaucratic structures.

The idea for a temporary, informal Roundtable has been gaining ground. Such a Roundtable, involving representatives of the relevant stakeholders such as IASB, CESR, FEE, UNICE, audit firms, national standard-setters and preparers, would gather diverging national and local interpretations or guidance given on IFRS. It could then proceed and group together those issues that give cause for common concern and recommend, where necessary, that these should be taken up by IFRIC. But let me already make it clear that the Roundtable will not be making any interpretations. That is the task of IFRIC. And neither would the Roundtable be used as a platform to review decisions taken by enforcers.

Use of IFRS in other jurisdictions

It is my firm belief that accounting standards should be international and be used across the globe. We have committed to use IFRS, but other important markets – notably the US – have not yet done so.

Our interest in the acceptance of IFRS in the US is of course not purely altruistic. Today there about 250 EU issuers listed in the US using IFRS. The cost of the current US GAAP reconciliation requirement is enormous. I have heard estimates of between \$1 million and as much as \$10 million for the largest companies. And that is every year. But the story does not end here. There are many companies from other jurisdictions who also have US listings and use IFRS. That is why I think my agreement earlier this year with the former SEC Chairman,

Bill Donaldson, and the SEC roadmap to remove the US GAAP reconciliation requirement is so important. This Roadmap means that IFRS could be accepted in the US no later than 2009, or even sooner.

We very much appreciate the efforts by our colleagues in the SEC to advance this issue, and continue to work positively on the Roadmap.

Convergence is not an invitation to standard-setters to try and advance the theoretical frontiers of accounting

Equivalence between third country GAAP and IFRS

In the EU we are looking into the use of third-country GAAP in order to establish whether these should be considered equivalent with IFRS. The Commission intends to address the issues arising under the Prospectus and the Transparency Directives before 1 January 2007.

CESR has now delivered its technical advice and indicated that there would be need for more time before major third country GAAPs (US, Japanese and Canadian GAAP) could be considered fully equivalent with IFRS.

For the moment, my personal view is that the best way to proceed may be for the EU to defer an equivalence decision and prolong the status quo, rather than taking any decision now. This option would align the equivalence agenda on both sides of the Atlantic and allow time for consolidating our experience of working with IFRS in practice. I am currently discussing with Member States and consulting major stakeholders on this approach.

Convergence between accounting frameworks

Convergence of existing accounting frameworks is important for the development of a truly international set of accounting standards. But we must first

define our terms. What do we actually mean by 'convergence'? From my perspective, our objective is to have an effective process up and running that will reach a sufficient level of convergence within a reasonable timeframe. We are not seeking to establish an absolute level of convergence. This would be unrealistic and the end point would probably be somewhere near to infinity. Although traditionally convergence has concentrated on the US GAAP/IFRS axis, we should not forget that today, convergence is not just limited to US GAAP. Other important and major jurisdictions are also seeking to more closely align their national accounting standards with IFRS and engage in fruitful co-operation with the IASB. Japan and of course China are two obvious examples.

The convergence objective has been elevated to the supreme goal in the work plans of the IASB and the FASB. But one must not lose sight of the fact that convergence is a tool, not an end in itself. There is increasing concern in the business community in the EU that the convergence objective may lead to a new generation of complex and untested accounting standards.

The convergence exercise must be a two-way street and it must not be allowed to destabilise the IFRS platform in Europe. I would like to stress that convergence is not an invitation to standard-setters to try and advance the theoretical frontiers of accounting. I will not take on board any revolutionary new standards. This should be a practical exercise, firmly anchored in business reality, to be undertaken in the interests of users and investors. The main objective is to try and narrow the differences between the existing standards, not to make accounts even more indigestible with a whole set of new standards! We will not be adding new carriages to the IFRS train, just as it has left the station.

Conclusion

I am delighted that FEE is playing such an important role in these developments. We must rise to and meet the IFRS challenge. Continued co-operation will be essential. I, for one, intend to put every effort into making sure the EU does meet the challenge.

IFRIC rejections

This table lists some of the items that have not been taken onto the agenda of the International Financial Reporting Interpretations Committee and the explanations for their rejection. The explanations are provided for information purposes only and do not represent or change existing IFRS requirements. They reflect past deliberations of IFRIC, as published in *IFRIC Update*, and may not reflect subsequent developments. The list covers the more significant issues only and is not exhaustive.

Standard	Subject and rejection date	Issues
IAS 2, Inventories	Discounts and rebates – November 2004	Settlement discounts should be deducted from the cost of inventories. Rebates that specifically and genuinely refund selling expenses should not be deducted from the cost of inventories.
IAS 12, Income Taxes	Deferred tax relating to finance leases – June 2005	IFRIC declined to develop any guidance, although there is diversity in practice, because the issue falls directly within the scope of the Board's short-term convergence project on income taxes. An exposure draft is expected later this year.
IAS 16, Property, Plant and Equipment	Depreciation of assets under operating leases – November 2004	The use of the interest method of depreciation is not appropriate.
IAS 17, Leases	Finance subleases of finance leases – June 2005	IAS 17 is clear on the guidance for finance leases both for the intermediary in its capacity as lessee and a lessor and for the end user as a lessee. The derecognition requirements of IAS 39, as they apply to the finance lease liabilities of the intermediary, is also clear.
	Time pattern of user's benefit from an operating lease – November 2005	IAS 17 requires a straight line pattern of recognition of income or expense from an operating lease unless another systematic basis is more representative of the time pattern of the user's benefit. Recognising income or expense from annual fixed inflators as they arise would not be consistent with the time pattern of the user's benefit.
IAS 18, Revenue Recognition	Extended payment terms – July 2004	Accounting for a receivable arising from extended payment terms such as six months interest-free credit should include the time value of money when material.
	Prompt settlement discounts – July 2004	Discounts should be estimated at the time of sale and presented as a reduction in revenues.
IAS 27, Consolidated and Separate Financial Statements	SIC-12 – November 2002	The 'majority' of benefits or risks in SIC-12 refers to the majority of the variability of expected economic outcomes rather than the absolute economic outcome.
IAS 37, Provisions, Contingent Liabilities and Contingent Assets	Onerous contracts and operating leases – December 2003	IFRIC declined to issue guidance as the IASB is considering, as part of its convergence project on IAS 37, additional guidance to the existing requirements to make it clear that if a contract becomes onerous as a result of an entity's own actions, no provision is recognised until that action occurs.
	Effective interest rates and future credit losses – October 2004	IAS 39 is clear that when calculating effective interest rate, an entity should not consider future credit losses.
IAS 32, Financial Instruments: Presentation and Disclosure	Convertible instruments denominated in a foreign currency – April 2005	IFRIC agreed that an obligation denominated in a foreign currency represents a variable amount of cash. Therefore contracts that will be settled by an entity delivering a fixed number of its own equity instruments in exchange for a fixed amount of foreign currency should be classified as liabilities. IFRIC recommended that the IASB amend IAS 32; however, the IASB declined to make changes to the standard.
IFRS 6 Exploration for and Evaluation of Mineral Resources	Exemption from the hierarchy is limited to the exploration and evaluation phase – November 2005	The exemptions in IFRS 6 do not extend to activities before or after the exploration and evaluation phase.

