

IFRS News

Shedding light on the IASB's activities*

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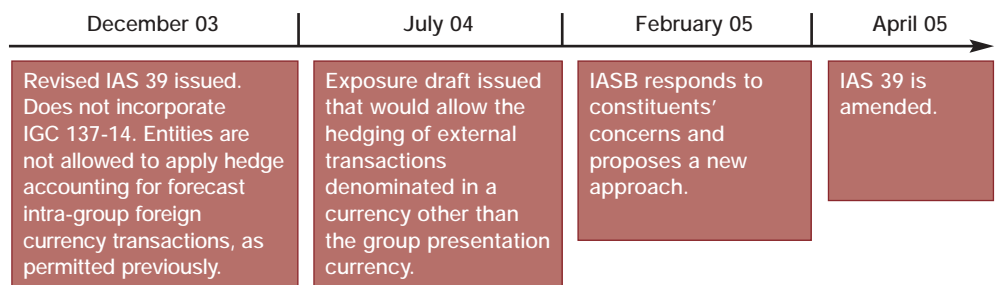
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Issue of the month

IAS 39 amendment

The new amendment to IAS 39 has provided clarity on what type of intra-company foreign currency hedges will qualify for hedge accounting, led to increased convergence towards US GAAP and given some transition relief. Sandra Thompson and Marc Minet explain.

The amendment permits hedge accounting for some commonly used hedging strategies. It introduces guidance similar to that in IGC 137-14. This IGC was deleted in the version of IAS 39 published in December 2003.



What are the changes?

Multinationals commonly hedge the foreign currency risk arising from intragroup forecast transactions. IAS 39 does not permit an intragroup item to be a hedged item, but there is an exception for intragroup monetary items that are not fully eliminated on consolidation. This exception has been extended in the amendment. The foreign currency risk of an intragroup forecast transaction can now be the hedged item in consolidated financial statements provided that the hedged intragroup transaction:

- (a) is **highly probable** and meets all the other hedge accounting criteria (other than the requirement that it should involve a party external to the group);
- (b) is **denominated in a currency other than the functional currency** of the entity entering into that transaction (under IAS 21, a foreign currency exposure arises only when a transaction is denominated in a currency other than the functional currency of the entity entering into that transaction); and

(c) gives rise to a foreign currency risk exposure that will **affect consolidated profit or loss**.

Condition (c) will be met if the forecast intragroup transaction is related to an external transaction. A common example is a forecast sale of inventory between members of the same group that is related to an expected onward sale of the inventory to a party external to the group. However, condition (c) is unlikely to be met for transactions such as intragroup royalty payments, interest on intragroup loans or intragroup management fees.

Any hedging gains and losses that are initially recognised in equity are reclassified to profit or loss in the same period that the foreign currency risk of the hedged transaction affects consolidated profit or loss. This would be when the onward sale to the external party occurs (and not when the intragroup sale occurs).

The changes move IFRS towards US GAAP, without complete convergence. US GAAP allows forecasted intragroup transactions, such as royalty payments, to be designated as hedged items.

Example: Forecast intragroup sale of inventory

Group A, presentation currency of GBP, includes Entity B, a subsidiary with euro functional currency, and Entity C, a subsidiary with US dollar functional currency.

Entity B incurs most of its production costs in euros. It sells most of its production to Entity C and those transactions are denominated in US dollars. Entity C sells the product on to external customers, also in US dollars.

Entity B forecasts in June 2005 that it will sell in October 2005 USD 100m of inventory to Entity C. These sales are highly probable, and all the other conditions in IAS 39 for hedge accounting are met. Entity C expects to sell this inventory to external customers in early 2006.

Entity B in June 2005 enters into a euro/USD derivative to hedge the expected sale of USD 100m to Entity C in September 2005.

The forecast intragroup sales of USD 100m can be designated in the consolidated financial statements as a hedged item in a cash flow hedge of the currency risk associated with them. All three of the conditions outlined above are met since:

- (a) the sales are highly probable, and all the other conditions for using hedge accounting are met;
- (b) the sales are denominated in a currency (USD) other than Entity B's functional currency (euros); and
- (c) the existence of the expected onwards sale of the inventory to third parties results in the hedged exposure affecting consolidated profit or loss.

Gains and losses on the euro/USD derivative are recognised initially in consolidated equity, to the extent the hedge is effective. These amounts are reclassified to consolidated profit or loss in 2006 when the external sales occur.

Hedge accounting could also be achieved if Entity B or Entity C was an associate, joint venture, branch or the parent, rather than being a subsidiary.

Transition arrangements

Effective date

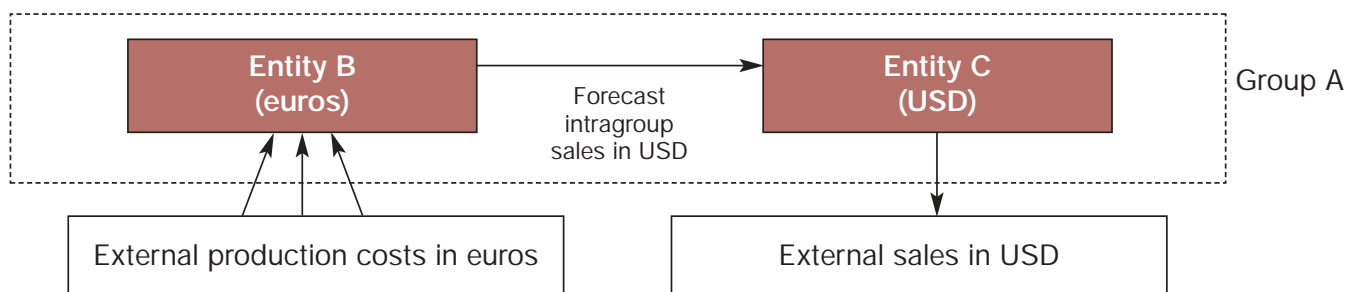
The amendment is mandatory for annual periods beginning on or after 1 January 2006. Earlier application is encouraged.

Entities (existing users of IFRS and first-time adopters) with calendar year-ends are not required to apply the amendment for the year ending 31 December 2005, although they are permitted to do so via early adoption. However, the EU has not yet endorsed the amendment. This may be an issue for EU entities that wish to adopt the amendment early and whose interim financial statements are required to comply with accounting standards applicable in the EU. Such entities will not be able to apply the amendment in their interim financial statements until it is endorsed by the EU.

Ability to designate external transactions in the entity's functional currency

Entities will be able to obtain hedge accounting only for periods (including comparative periods) for which they have the correct hedge designation in place. This is unlikely to be an issue for existing users of IFRS that previously relied on the guidance in IGC 137-14, as designations made in accordance with this IGC will comply with the amendment. Entities that apply IFRS in separate financial statements may have put the necessary designations in place in order to achieve hedge accounting in the separate financial statements.

The appropriate designation may not exist in the case of first-time adopters that are considering early adopting the amendment for 2005. The necessary designations may not have been in place



at the start of the accounting period (January 2005), as the amendment was not issued until April 2005. Such entities, therefore, if they early adopt the amendment for 2005, will not be able to obtain hedge accounting for the entire year. In particular, some entities may have designated the hedged item as an external forecast transaction denominated in same currency as the functional currency of the entity entering into it, as the exposure draft issued in July 2004 that preceded the amendment proposed to permit such designation.

The amendment gives specific transitional relief to such entities for 2005 only: it permits them to obtain hedge accounting based on these designations provided they would have qualified for hedge accounting had the transaction not been denominated in the functional currency of the entity entering into it.

Relief from restating comparatives

There is one further transition relief in the amendment. It relates to the period

in which gains and losses initially recognised in equity are reclassified in profit or loss.

An existing user in 2004 would have recognised hedge gains and losses in the income statement when internal transactions occurred.

The amendment shifts income statement recognition to the point of the external transaction. Companies will not be required to restate prior-year comparatives for this change.

IAS 34



Interims for first-time adopters

Many listed groups are considering the form that their first interim reports will take under IFRS. This is an urgent issue for those that report quarterly. IAS 34 is not mandatory, although many investors and analysts will expect companies to apply it. This raises an interesting question for European groups, which will adopt EU-endorsed standards. How should they approach standards that are not yet endorsed? This and related issues are discussed in a second article next month. This month, we look at form and content, accounting policies and recognition and measurement. By Peter Hogarth.

Form and content

IAS 34 gives management a range of options for interim reporting. A company can publish full primary statements (with a complete set of notes), condensed primary statements (with selected notes) or something in between the two.

An entity that publishes condensed financial information or full primary statements supported by selected notes should ensure it is also satisfying IFRS 1. The first IFRS interim report under IFRS 1 should contain sufficient detail to enable users to understand the material adjustments to the balance sheet and income statement.

Some entities may need to present the full extent of the information illustrated in the PwC publication 'Illustrative Interim Consolidate Financial Statements 2005 – for first-time adopters of IFRS' if the

impact of the transition to IFRS is to be understood. Others may be able to explain the change by presenting condensed information. It is vital that the transition to IFRS is clearly explained, whatever form of presentation is chosen. Financial markets react adversely if the impact is not understood. Investors and analysts might expect more information to be included in the first IFRS interim report than in future periods.

Accounting policies

IAS 34 requires the interim report to be prepared in accordance with the accounting policies applied in the entity's most recent financial statements, except for any changes in accounting policy that are to be reflected in its next annual financial statements. The interim report is prepared using accounting policies based on existing IFRS that are to be applied at the year-end.

Recognition and measurement

IAS 34 requires items to be recognised and measured at interim dates in the same way as at a year-end. Entities should not make adjustments to 'smooth' the effects of seasonal revenues or uneven cost profiles, although the disclosure of seasonality is required. Events in a later interim period should not be anticipated in an earlier interim report.

This principle has some important implications. Items measured at fair value will need to be re-measured if an interim balance sheet is prepared in a similar way to a year-end balance sheet. This may be straightforward in some cases, but there may be practical problems where an entity has a defined benefit pension plan or assets measured at fair value.

Neither IAS 34 nor IAS 19 specifies how frequently the assets and liabilities of a defined benefit plan should be measured. However, IAS 19 requires an entity to determine the present value of the defined benefit obligation and the fair value of the plan assets with sufficient regularity that the amounts recognised in the financial statements do not differ materially from the amounts that would be determined at the balance sheet date. In other words, the impact of any actuarial gains and losses since the last valuation should be immaterial. This may be the case where an entity follows the 'corridor approach' and recognises only a small proportion of actuarial gains and losses; it will be more difficult to reach such a conclusion where actuarial gains and losses are recognised immediately, as permitted by IAS 19 revised. Entities following the immediate

recognition approach may need to obtain a valuation at each interim balance sheet date.

Other items measured at fair value (such as certain financial instruments and investment properties) will need to be re-measured at the interim balance sheet date. IAS 34 recognises that there will be a greater use of estimates at an interim date. Estimates might include internal valuations. However, where the methods of measuring fair value used in an interim report differ from those that would be used at a year end, the nature and effect of such differences should be disclosed.

An exception to the principle of treating an interim period as a discrete reporting period concerns taxation. Taxation is assessed annually, so the tax expense or credit cannot be properly determined

until the end of the financial year (or, if different, the tax year) when all allowances and taxable items are known. Calculating tax on the basis of the results of an interim period in isolation could result in the recognition of a tax figure that is inconsistent with entity's overall tax burden. Taxation expense should therefore be recognised in each interim period based on the best estimate of the effective tax rate expected for the full financial year. This percentage should be applied to the interim result; the tax should be recognised rateably over the year as a whole. Amounts accrued in one interim period may have to be adjusted in a subsequent interim period if the estimate of the effective annual tax rate changes.

Peter Hogarth is a director in PwC's UK accounting technical group.

Interview



IASB tackles 'son of IAS 39'

PwC partner and member of the IASB's financial instruments working party, Pauline Wallace, talks to IFRS News about the working party's objectives and agenda.

How has the group's agenda been set?

We have had two meetings to date, the first to examine what individual members want to achieve. We considered what we don't like in the current standard, so that we can focus on what changes need to be made. We set out our priorities, which are hedge accounting, fair value and derecognition.

In terms of hedge accounting, we are particularly interested in moving to a simpler form of hedging that takes into account that most companies hedge on a portfolio basis. We also talked about companies' risk management strategies and how to use these as a basis for hedge accounting.

Our discussions on fair value fell into two categories: how to fair value – there

was concern that some methodologies were not sound and that more thought needs to be given to the principles underlying fair values; and what to fair value. Here, we looked at getting rid of some categories of assets. There is currently available for sale, which are at fair value through equity, and held to maturity, which are amortised cost. Do we need these separate categories, or should we be able to carry certain assets at amortised cost and everything else at fair value through the income statement? There was a range of views around the table on the extent to which fair value is appropriate but all agreed that we need to retain a mixed measurement basis for a while.

As regards derecognition, everyone agreed this is a problem, but we have no proposed solutions yet. This is something we will return to in the future.

How have discussions on these topics developed?

We looked in more detail at the first of these issues in our second meeting. We had presentations from corporates, investment banks and retail banks on how they each do hedge accounting and their strategies. Then one of the users presented the information he would need if we were to change the principles of hedge accounting.

We identified a few issues that could be dealt with as a 'quick fix'. Examples of quick fixes are how to hedge cash flows that arise from a combination of derivatives and non-derivatives, which cannot currently be hedged, and effectiveness-testing for fair value hedges. Life would be made a lot easier for preparers if we could clear up issues such as these. If the Board

decides to go ahead with either of them, it will produce a template for us to use as a basis for other short-term fixes. Short-term fixes would hopefully be effective in 2006. The longer term 'son of IAS 39' is unlikely to be finalised within five years.

We also discussed fair values. The US is about to produce a fair value standard, and the IASB is assessing whether there is need for convergence with the US standard, as it's not identical to IFRS. However, there is a question of resources to be able to do

this. So we have the prospect in a couple of months of having differing requirements on fair values in IFRS and US GAAP.

Members of the IASB's insurance working party joined our second meeting, as they also have fair value on their agenda. Insurers tend to look at liability valuations, whereas banks and corporates tend to look at asset valuations. There is a need to pull these two interests together. But the insurance group is interested in our discussions on the assets side too and

it obviously wants to be included in the debate.

Working closely with the IASB's working group on performance reporting is also important in the context of the hedging issue. Ideas on hedging have to be developed bearing in mind whether or not there is a single performance statement; there's no point in deferring gains and losses in equity if it's all part of the same statement. There's a lot of inter-relationship between the three working parties. Going forward, we may need to form some sub-groups to discuss common issues.

IASB financial instruments working group – objectives and membership

The IASB announced the membership of its financial instruments working group in September 2004. Its aim is, 'to improve, simplify and ultimately replace IAS 39 and examine broader questions regarding the application and extent of fair value accounting'.

Name	Title	Organisation	Country
Melissa Allen	European Head of New Business and Technical Accounting Support	Credit Suisse First Boston	UK
Jeannot Blanchet	Managing Director - Equity Research	Morgan Stanley	France
Joseph Boateng	Manager, Pension Funds	Johnson & Johnson	US
Philippe Bordenave	Group Chief Financial Officer	BNP	France
Gunther Gebhardt	Professor	Johann Wolfgang Goethe University	Germany
Mark Kirkland	Vice President, Corporate Treasury	Philips	Netherlands
François Masquelier	Head of Corporate Finance and Treasury	RTL	France
Esther Mills	First Vice President, Head of Accounting Policy	Merrill Lynch	US
Ralph Odermatt	Managing Director, Head of Group Accounting Policies and Support	UBS	Switzerland
Russell Picot	Group Chief Accounting Officer	HSBC	UK
Francis Ruijgt	Corporate Insurance Risk Management, Deputy Chief Insurance Risk Officer	International Actuarial Association/ING Group	Netherlands
Yoshio Sato	Partner in Financial Industries Group	Deloitte	Japan
Elisabeth Schmalfluss	Head of Accounting and Controlling Policies	Siemens	Germany
Sadaki Takagi	Senior Director for Bank Accounting	Japanese Bankers Association	Japan
Bob Uhl	Partner	Deloitte	US
Pauline Wallace	Partner in IFRS Services	PwC	UK
Peter Zegger	Corporate Centre Controller	Unilever	Netherlands

Observers

- Basel Committee on Banking Supervision
- European Central Bank
- European Financial Reporting Advisory Group

- International Organization of Securities Commissions
- Committee of European Securities Regulators
- Securities and Exchange Commission

Also participating: FASB staff

Do you believe the working party can be truly effective?

It is an honour for me to be in this group. It's useful to have insurers, banks and corporates around the same table so that we can spot common themes. Although banks have different strategies from corporates, there are similarities in

the ways they manage their risk.

The establishment of these working parties is a great indication that the IASB is serious about listening to its constituents.

Now that the Board has published IAS 39, it can concentrate on a more manageable agenda. It couldn't have gone into 2005

with IAS 39 as it was. This is the opportunity now to get broader input.

We need to make the most of this opportunity. I am open to input from anyone from around the firm or from clients if there are issues that people would like to get onto the agenda. Let's get PwC's thoughts on the table.

IFRS training events



PwC internal IFRS training events

The Asia-Pac and EMEA IFRS update training events this month mark the beginning of the seventh training season for IFRS. They will provide attendees with up-to-date IFRS knowledge and the chance to network with their colleagues across the region. GCRG training partner Mary Dolson explains.

This May, nearly 200 PwC professionals will head to Singapore for the 2005 IFRS Technical Update. Another 320 are expected to attend the two EMEA events, held in Warsaw on 23-24 and 26-27 May.

The annual update events provide the opportunity for experts to deliver the technical training material developed by GCRG. This material is then cascaded to wider groups of partners and managers in all countries where IFRS is important to the practice.

The format has changed from previous years' mandatory sessions to an all-elective approach; delegates will be required to choose seven elective sessions. Detailed course descriptions went out with the event invitation.

Attendees have a choice of 25 modules in three groups: essentials, practitioners and master class. The 'master class' will focus on financial instruments and business combinations.

'We looked at the training event feedback from previous years and realised that

we've always struggled to cater for those who wanted to hear about cutting-edge developments in standard-setting,' said Mary. 'On the flip side, those that wanted to refresh or establish their skills in a particular area found that an update-focused event did not work for them.'

The new format requires more instructors than in previous years, so additional IFRS experts outside the Global Corporate Reporting Group will join the instructor team: from Germany, the UK, and the US for the Warsaw events; from Australia, China, Hong Kong and the US at the Singapore event.

Class sizes will be smaller so participants can provide input and ask relevant questions. They learn from the technical experts and in turn, have the chance to add to the instructors' knowledge by offering fresh perspectives.

These training events give attendees the chance to improve their IFRS knowledge and to share experiences with other colleagues, says Mary. 'It's a mix of client-facing professionals, technical

experts, and those in industries that creates good dialogue and new angles.'

The evening entertainment will also provide opportunities for attendees to network with their colleagues. Sadly the 'IFRS Idol' game show will not run this season. Rumour is that it may reappear if there is sufficient demand in future training seasons. A casino night will take place this year on the evening of the first day of each Warsaw event. Attendees of the Singapore event will enjoy dinner at the famous Raffles Hotel.

'PwC makes an enormous investment in training. The theatre events are the culmination of the development process. They are really just the tip of the iceberg when compared to the cascade at national level, which thousands of professionals across the global network will attend. The training events show that PwC takes maintaining our IFRS expertise seriously,' says Mary.

The training events for the US, the Caribbean and SOACAT will take place later this year.

Guest presenters at the training events

Singapore

- Jan McCahey – Australia
- Yvonne Kam – China
- Ian Farrar – Hong Kong
- Tommy Fung – Hong Kong

- Eng beng Choo – Singapore
- Bud Thomas – US
- Marie Kling – US

Warsaw

- Fabio Cajazeira – Brazil
- Tadeu Cendon – Brazil
- Bernd Roese – Germany
- Richard Burger – Switzerland
- Peter Holgate – UK

- Iain Selfridge – UK
- Anne Simpson – UK
- Sara de Smith – US
- Marie Kling – US

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