

# RSM Reporting

**Welcome from  
the Editor**  
Marco Mongiello

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

*In this issue:*

**Section 1: Accounting and reporting this quarter**

*Updates from the IASC/IASB and EFRAG*

**Section 2: The point of view of ...**

*...David Cairns (guest contributor) on Leases*

*...Kees Roozen on Investment properties entities - a survey*

*...Jane Meade on Revenue recognition - the latest developments*

*...Olga Panchenko on IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities*

**Section 3: Top Ten Topics in IFRS**  
by Joelle Moughanni

A common message emerges from the articles of this edition: the newest developments in accounting and reporting practice seem to be proving more difficult to achieve than expected.

With the developments on leasing coming along at such a pace, our guest contributor, David Cairns, found it almost challenging to set a final date to which to refer as the 'time of writing'. He certainly succeeded though in shedding light on this very fluid matter, which we started to cover in Issue 2 and will continue to keep an eye on, until it becomes more established.

Revenue recognition, being subject to such relevant developments, also deserved a second follow up (see Issues 1 and 6). If it is not yet possible for anyone to provide a final version on this matter, Jane Meade does provide an insightful account of its status, highlighting some critical points arising from the re-deliberations and RSM International's contribution to their achievement.

The Consolidation topic, as addressed by Olga Panchenko, is no exception in terms of difficulty in tracking down a firm decision. Olga provides an extremely valuable account of its status quo, though, and what to expect in the near future on this front.

It is in the philosophy of this newsletter that the contributions build on the professional experience of their authors, which makes their articles alive and very close to the account preparers' and users' interests. Kees Roozen took a step further in this direction, as he carried out a pan-European survey among reporting firms. His article addresses typical aspects of investment properties' business and their respective accounting and reporting challenges.

Joelle Moughanni closes this edition with her Top Ten Topics page, with the ever controversial subject of financial instruments, focusing on the latest developments of the reporting practice on hedging.

Enjoy your reading and contact the editorial team if you would like to take an active part in the debate.

**Dr Marco Mongiello ACA**  
**E: [m.mongiello@imperial.ac.uk](mailto:m.mongiello@imperial.ac.uk)**

# 1 Accounting and reporting this quarter

## IASC/IASB

>> go to [www.ifrs.org](http://www.ifrs.org) to follow up any of the following news

### IASC/IASB

#### March 2011

The IASB and FASB have continued their discussions on insurance contracts by considering a wide range of topics. The Boards' activity on this matter has been significantly intensified and should culminate shortly in an Exposure Draft (ED) on insurance.

The Boards have put considerable effort into leases. Their decisions resulted in important redeliberations, which are covered in our guest contributor's article.

The IFRS Foundation has published the IFRS Taxonomy 2011 and has established a task force to examine detailed XBRL (eXtensible Business Reporting Language) tagging in IFRS financial statements, and is looking to work directly with preparers from listed companies from different industries and regions. The aim of the task force is for listed companies to produce fully-tagged financial statements using the IFRS Taxonomy. The task force will be a means by which the Foundation can engage with stakeholders and obtain feedback on the usability of the IFRS Taxonomy for filers and for users of filed XBRL content in the context of detailed note tagging.

#### April 2011

The IASB and FASB have further progressed with their discussions on insurance contracts and on leases.

The IASB and FASB published a progress report on their joint work to improve IFRSs and US GAAPs and to bring about their convergence. Since their report last November, the boards have completed five projects, given priority to the three remaining Memorandum of Understanding projects, as well as insurance accounting and provided for further time to finalise their convergence work. Commenting on the progress report, Sir David Tweedie, Chairman of the IASB, said: "The convergence programme continues to raise the standard of financial reporting worldwide, delivering much-needed improvements in key areas and providing a solid platform for global high quality standards" and Leslie F. Seidman, Chairman of the FASB, said: "The progress report highlights the many areas where we have already improved and converged our standards, and our plans for completion of the priority projects."

#### May 2011

The IASB and FASB have more activities on Insurance contracts.

The IASB has completed its improvements to the accounting requirements for off balance sheet activities and joint arrangements by issuing IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements and IFRS 12 Disclosure of Interests in Other Entities. The completion of this review brings the accounting treatment for off balance sheet activities in IFRSs and US GAAPs broadly into alignment, and

concludes an important element of the IASB's comprehensive response to the financial crisis.

The IASB and FASB have issued new guidance on fair value measurement and disclosure requirements for IFRSs and US GAAPs. The guidance completes a major project of the boards' joint work to improve IFRSs and US GAAPs and to bring about their convergence and represents an important element of the boards' response to the global financial crisis. Completion of the project is the culmination of more than five years' work to improve and align fair value measurement and disclosure requirements.

For IFRSs, IFRS 13 Fair Value Measurement will improve consistency and reduce complexity by providing, for the first time, a precise definition of fair value and a single source of fair value measurement and disclosure requirements for use across IFRSs. For US GAAPs, the Update will supersede most of the guidance in Topic 820, although many of the changes are clarifications of existing guidance or wording changes to align with IFRS 13.

Sir David Tweedie, Chairman of the IASB, said: "The finalisation of this project marks the completion of a major convergence project and is a fundamentally important element of our joint response to the global financial crisis. The result is clearer and more consistent guidance on measuring fair value, where its use is already required." Leslie F Seidman, Chairman of the FASB, said: "This Update represents another positive step toward the shared goal of globally converged accounting standards. Having a consistent meaning of the term 'fair value' will improve the consistency of financial information around the world."

## EFRAG

>> go to [www.efrag.org](http://www.efrag.org) to follow up any of the following news

### EFRAG

#### March 2011

EFRAG has issued a rather critical comment letter on the IASB's ED Hedge Accounting, issued in December 2010. The ED proposes significant changes to hedge accounting for hedges of individual and closed groups of items. EFRAG nevertheless agrees with the direction of the proposals in the ED, and in particular with reference to the direction of the proposed objective to reflect, in the financial reporting, the extent and effects of an entity's risk management activities.

The IASB and EFRAG met to discuss EFRAG's recommendations on the remaining three Memorandum of Understanding projects on financial instruments, leases and revenue recognition, as well as the project on insurance contracts.

#### April 2011

In its comment letter on the supplementary document to the ED Financial Instruments: Impairment, EFRAG welcomes the IASB's and the FASB's efforts in developing a common approach to accounting for the impairment of financial assets. It also supports the approach based on decoupling of interest income and credit losses. However, EFRAG does not support the proposals in relation to the "floor" and urges the IASB to clarify the objectives of the revised impairment model and to field test the proposals prior to finalising the standard.

In its comment letter on the ED Offsetting Financial Assets and Financial Liabilities, EFRAG welcomes the IASB's and the FASB's efforts to develop joint proposals for converged requirements for offsetting financial assets and liabilities. EFRAG supports the IASB decision to use, as a basis for the converged requirements, the existing guidance for offsetting financial assets and financial liabilities in IAS 32 Financial Instruments: Presentation and urges the IASB to consider the proposals in the ED in the context of the existing disclosure requirements in IFRS 7 Financial Instruments: Disclosures.

Throughout the month of April, EFRAG has increased the momentum of its outreach programme with most European constituents on Revenue Recognition and Leases.

#### May 2011

EFRAG has published its 2010 Annual Review, which reports an effective summary of its influence on the developments of IFRSs in the last year.

## 2 The point of view of ...

## Guest Contributor



### David Cairns

#### ...on The IASB's Proposals on Lease Accounting

The IASB has proposed a new lease accounting model<sup>1</sup> which will have a significant effect on the way that lessees present many leases in their statements of financial position and statements of comprehensive income, in particular leases that are currently classified as operating leases. The proposed model would require an entity to account for virtually all leases as if they are finance leases under the current model but with some added complexities. The proposals will increase reported net debt and gearing<sup>2</sup>. They will reduce reported profit in the early years of [finance]<sup>3</sup> leases but increase EBITDA and EBIT every year.

The main effects of the proposed model can be examined by means of a simple example which is also a useful starting point for identifying the complexities of the proposed model. Assume that an entity enters into a lease contract under which it will pay rent of £2m at the beginning of each year for 15 years in return for the use of an office building for the same period. Such a lease is very likely an operating lease under the current lease accounting model. Therefore, under the current model, the entity would recognise nothing on its statement of finance position (other than any prepaid rent during each year) and recognise £2m rent expense each year in its statement of comprehensive income.

Under the proposed 'right-of-use' model, the entity has to identify the assets and liabilities arising under all lease contracts and recognise those assets and liabilities on its statement of financial position. The obligation to pay the rent of £2m a year is a liability, which should be recognised on the entity's statement of financial position at the commencement of the lease. The right to use the building is an asset which should be recognised on the entity's statement of financial position at the commencement of the lease.

The liability is measured at the present value of the lease payments discounted using the rate the lessor charges the lessee (or if that rate is not available, at the lessee's incremental borrowing rate). Assume that the rate charged by the lessor is 8%. The present value of £2m paid at the beginning of each of the next 15 years using a discount rate of 8% is £18,488,474. Therefore, at the inception of the lease, the lessee measures the liability at £18,488,474<sup>4</sup>. It measures the asset at the same amount. This increases net debt and gearing (assuming that the lease liability is included in debt).

At the end of year one, the liability is measured at present value of £2m paid at the beginning of each of the next 14 years using a discount rate of 8%, which is £17,807,552<sup>5</sup>. This implies interest expense of £1,319,078 (after taking account of the rent payment of £2m)<sup>6</sup>. The asset is amortised using the straight-line basis, resulting in a carrying amount of £17,255,909 and amortisation for the year of £1,232,565. There is, therefore, a total charge to profit or loss of £2,551,643 for interest and amortisation compared with the charge of £2m for rental expense under the current model. In the later years of the lease, the effective interest rate method will result in lower interest charges with the result that, eventually, the total charge to profit or loss each year will be lower than the amount that would be recognised in those later years.

The proposed model increases EBITDA by the amount of rent expense because rent expense is no longer charged and interest expense and amortisation are not deducted when determining EBITDA. The model increases EBIT by rent expense less the amortisation of the asset because rent expense is no longer charged and interest expense is not deducted when determining EBIT. This may make the proposed model attractive to those entities that focus the attention of readers of their financial statements on EBITDA and EBIT rather than on bottom line profit.

Respondents to the IASB's proposals revealed mixed views on the effects of the proposed model on the statement of comprehensive income. Some were concerned about the replacement of rental expense by amortisation and interest expense. Many wanted to get back to the same charge to profit or loss as that reflected under the current model. Some suggested doing this by using the same amortisation model for both the right-of-use asset and the interest expense so that the profit or loss effects cancel out. The IASB has tentatively agreed to address this concern for those leases in which the financing element is not significant by restricting the amortisation of the asset to the difference between rent expense and interest expense. Implementing this decision will require the IASB to reinstate two categories of lease: finance leases (in which the financing element is significant) and other-than-finance leases (in which the financing element is not significant). These categories will affect only profit and loss recognition; they will not affect the recognition of lease assets and lease liabilities on the statement of financial position.

Even if the IASB resolves the concerns about the profit or loss effects of the proposed model, there are other wider concerns about the model. Many of these concerns stem from the fact that most lease contracts are not as straightforward as the simple example. Some of the complexity arises from structuring designed to get operating lease classification under the current model. Much of the complexity, however, stems from commercial needs to balance the interests of lessors and lessees. For example, for good commercial reasons, many leases allow the lessee to cancel or extend the lease term or include variable lease payments, for example, payments that are contingent on the lessee's revenues from using the leased asset.

The IASB proposed initially that the lease term should include the effects of any options to extend or cancel the lease and that lease payments should include expected contingent rentals. Both these proposals would add greatly to the complexity and cost of implementation of the proposed model. In addition, many respondents questioned whether the options and contingent rental arrangements created financial liabilities for the lessee at the commencement of the lease or at later dates prior to a decision to exercise an option or an event that triggers contingent rent payments. The IASB has responded to these concerns by limiting significantly the circumstances in which options to extend or cancel the lease and contingent lease payments are taken into account when measuring the lease liability and right-of-use asset at the commencement of the lease.

The proposed model does not apply to immaterial leases but would catch many short-term leases. The IASB initially proposed to simplify the accounting for some short-term leases by allowing the lessee to measure the liability and the right-of-use asset at the undiscounted amount of lease payments. This would still have meant an entity identifying, tracking and recognising a potentially significant number of short-term leases. The IASB has responded to these concerns by tentatively deciding to allow the lessee not to account for lease assets or lease liabilities for those leases with a maximum lease term of 12 months (this is similar to the current model for operating leases).

The IASB has also addressed lessor accounting. In this case, the challenge is to deal with the fact that the lease transfers some or all the benefits<sup>7</sup> embedded in the underlying asset to the lessee. Removing the underlying asset makes sense for those leases that are currently finance leases but makes little sense for those leases that are currently operating leases (for example, in the statement of financial position of an entity that operates a short-term car hire

business). The IASB proposed solving this problem by allowing a choice between a derecognition model (under which the leased asset is not recognised on the lessor's statement of financial position) and a performance obligation model (under which the leased asset is recognised on the lessor's statement of financial position).

The IASB had planned to complete its lease project by 30 June 2011 but has recently decided to take a further few months in order to permit further work and consultation with stakeholders. If the proposals are adopted by the IASB, they will not come into effect before 2015 at the earliest. For European companies, any resulting IFRS will have to be adopted by the EU which may not be an easy process given the opposition of the leasing industry and possible conflicts with tax law. Opponents should bear in mind, however, that the proposed model for lessees addresses a very significant area of off balance sheet financing, an area in which G20 leaders have called for improved accounting standards. If the leaders are serious in their calls, they will surely support the proposed model.

#### Guest Contributor: David Cairns

David Cairns is a member of the UK's Financial Reporting Review Panel and of the Assessment and Advisory Group of the World Bank Centre for Financial Reporting Reform. He also provides IFRS training and consulting services for preparers, auditors and users of IFRS financial statements ([www.cairns.co.uk](http://www.cairns.co.uk)) and directs public IFRS courses for IIR in Switzerland and the United Kingdom.

<sup>1</sup> Editor's note: we started to address this matter in Issue 2 of this newsletter and will keep covering it until an established position is reached. Hence, as the author noted, this text reflects the IASB's discussions up to and including the end of April 2011

<sup>2</sup> Note that the right to use asset does not enter into the calculation of net debt or gearing

<sup>3</sup> Editor's insertion

<sup>4</sup> Editor's note: this is:  $\text{£}2\text{m} + \text{£}2\text{m}/(1+0.08) + \text{£}2\text{m}/(1+0.08)^2 + \text{£}2\text{m}/(1+0.08)^3 + \dots + \text{£}2\text{m}/(1+0.08)^{14}$  given that in addition to the current year, i.e. year 0, there are 14 years of payments to be made

<sup>5</sup> Editor's note: this is:  $\text{£}2\text{m} + \text{£}2\text{m}/(1+0.08) + \text{£}2\text{m}/(1+0.08)^2 + \text{£}2\text{m}/(1+0.08)^3 + \dots + \text{£}2\text{m}/(1+0.08)^{13}$  given that in addition to the current year, i.e. year 0, there will be only other 13 years of payments to be made

<sup>6</sup> Editor's note: this is calculated as the difference between £2m (the rental expense) and the drop in the debt ( $\text{£}18,488,474 - \text{£}17,807,552 = \text{£}680,922$ )

<sup>7</sup> An asset is defined in terms of "future economic benefits" and it is the transfer of these benefits that leads to the possible double-counting

# 2 The point of view of ...



## Kees Roozen

### ...on Investment property entities - a survey

In January 2011<sup>8</sup> RSM Netherlands, together with E&Y<sup>9</sup> The Netherlands, published the results of a European survey on the 2009 financial statements based on IFRSs of investment property entities.

This survey focuses on the industry-specific application of IFRS by investment property entities as well as the application of industry-specific guidance (Non-GAAP Measures), especially as the credit crisis had a deep impact on the real estate sector.

The following items were surveyed:

1. Measurement of investment property, where a distinction was made between investment property (IP) and investment property under construction (IPUC)
2. Refinancing risk
3. Non-GAAP measures
4. Joint venture accounting and business combinations

#### Selection criteria

The top 50 entities<sup>10</sup> with a listing on a European Stock Exchange with main activities in investment property were selected. Due to a lack of information for six entities the population was 44.

## Results of the survey

### 1. Measurement

From 2009 onwards both IP and IPUC will be treated in accordance with IAS 40, despite the fact that the risks that accompany IP and IPUC are different<sup>11</sup>. For IPUC they also include building risk and vacancy risk.

For IP the (subsequent) measurement is at fair value or at cost. The survey found that 41 entities (93%) applied the fair value model. This is in line with earlier surveys and will also be the future model for US GAAP adopters. Most calculations of fair value were performed by external appraisers and the method of calculating the fair value was not disclosed only in one entity among those applying the fair value model. The guidelines on valuation used by the appraisers are not disclosed in the financial statements of 42% of the entities. Interestingly, only 24% of the entities that were surveyed showed a positive fair value change in the statement of comprehensive income, which leads to the conclusion that there still is a decrease in fair value due to the credit crisis.

<sup>8</sup> The article was published, in Dutch, in the Netherlands in a magazine for auditing and business economics ('Maandblad voor Accountancy en Bedrijfseconomie'), issue 1/2 January/February 2011

<sup>9</sup> E&Y stands for Ernst & Young Accountants LLP

<sup>10</sup> Editor's note: all ten Dutch listed entities in investment property and the 40 largest European listed investment property entities

<sup>11</sup> Before 2009 IPUC was treated under IAS 16 Property Plant and Equipment and was mostly measured at cost. From 2009 onwards IPUC have to be measured in the same way as IP will be measured (at fair value or at cost)

Due to more uncertainty in measuring the fair value of IP, entities disclosed their measurement of the fair value of investment property as an estimation uncertainty. In those cases the assumptions and the method used should be disclosed. So the vacancy rate, initial yield, the discount rate and a sensitivity analysis for those assumptions should be disclosed. The recommendation<sup>12</sup> coming out of our survey is to disclose the assumptions and the uncertainties, like yield, discount rate, vacancy rate and a maturity schedule for the rentals.

75% of the entities had IPUC in their portfolio. The table shows for those 33 entities how the IPUC was presented in the financial statements.

IPUC in the portfolio	Number	%
Balance sheet	12	36.4
Disclosure	13	39.4
No information	8	24.2
<b>Total</b>	<b>33</b>	<b>100.0</b>

The number with no information (24%) is high, due to the fact that IP and IPUC have different risks as stated earlier.

Twenty eight of the 33 entities that had IPUC in their portfolio have treated it as an accounting policy change for 2009 (85% of the entities with IPUC in their portfolio). Five entities (15%) did not apply an accounting policy change (still at cost, revaluations were presented in the revaluation reserve or the change in accounting policy was adopted the year before).

IAS 40 indicates that the change in accounting policies should be applied prospectively. Prospective application of a standard means to apply the new accounting policy to transactions, other events and conditions occurring after the date at which the policy was changed. The transitional provision of IAS 40 provides that fair values at previous dates are therefore not required and no comparatives have to be revised.

Policy 2008	Accounting policy change	Number	%
Fair value	Prospective (revaluation reserve to other reserves)	3	10.7
	No change due to fair value changes already in comprehensive income	1	3.6
	No effect, due to no revaluation reserve	1	3.6
Cost	Prospective with effect in equity	1	3.6
	Prospective with effect in comprehensive income	14	50.0
	No effect	3	10.7
	Not disclosed	5	17.8
<b>Total</b>		<b>28</b>	<b>100.0</b>

<sup>12</sup> Our recommendation especially refers to the maturity schedule for rentals as a standards framework. The assumptions, method and sensitivity analysis relate to IAS 1p125 and IAS 1p129

The accounting policy change that occurred was IPUC originally at cost changed into fair value with fair value movements in the statement of comprehensive income.

### 2. Refinancing risk

As a result of the credit crisis entities have more difficulties with refinancing their activities. Furthermore, due to the decrease in value for IP, the entities have faced lower solvency ratios and, in some cases, breaches of their loan covenants. This resulted in long-term loans required to be presented as current liabilities (on demand). This is also the case when a waiver of the bank was received after year end with disclosures in the notes.

Nearly all entities presented general disclosure on the loan covenants they have with the banks. The different loan covenants were mentioned, like the loan to value and the interest coverage ratio, but virtually no quantitative information was given (no limits in the loan agreements or no information on the range of these ratios during the year in relation to the limits).

For five entities the loan covenants were breached. In two of them a reclassification was presented in the balance sheet from non-current to current liabilities. Three of these five entities disclosed a separate paragraph in relation to going concern. This paragraph states the risks the entity is facing due to the credit crisis and concludes the financial statements were prepared on a going concern basis on the basis of management judgments. This paragraph on going concern is also included in another three entities with no breaches of the loan covenants.

In none of the financial statements did this result in a qualified auditor's report. However, in two of the three financial statements with breaches there was an emphasis of matter in the auditor's report regarding going concern.

### 3. Non-GAAP measures

The European umbrella organisation for real estate, (EPRA<sup>13</sup>), issued its Best Practice Recommendations in October 2010 in which performance measures are also recommended to be provided in financial reports by investment property entities in order to enhance transparency, uniformity and comparability between those entities. These performance measures are recommended because they provide more relevant information for investors in the real estate sector than would be provided under IFRS.

In our survey the following alternative performance measures have been taken into account:

- » The direct and indirect result
- » The direct result is the result based on income and expenses of the IP, except for the revaluations of IP, which are kept under the indirect result
- » The 'like-for-like- growth' which is the growth achieved by the entity itself, without acquisitions or divestitures
- » The EPRA NAV and triple NAV<sup>14</sup>
- » The EPRA NAV includes the NAV of the entity based on the fair value of the entity for the long term (excluding derivatives for hedging purposes and deferred taxes). The triple NAV includes the fair value of the entity including all items at fair value

The direct and indirect result was disclosed by 18% of the entities, where 75% of them made the disclosure in the primary statements and 25%

<sup>13</sup> EPRA, the European Public Real Estate Association, represents the publicly traded real estate sector in Europe

<sup>14</sup> NAV stands for Net Asset Value. EPRA NAV is based on the fair value of the entity but excludes (1) derivatives for hedging purposes and (2) deferred taxes. The triple NAV is based on the EPRA NAV and (3) add back the fair value of the derivatives for hedging purposes

in the notes. All of them provided a good definition as to what these results comprise and gave a reconciliation to the figures in the financial statements. In 75% of cases it was disclosed that these are non-GAAP measures.

The like-for-like growth and the NAV's were included in fewer financial statements than the disclosures on direct and indirect result (48% for like-for-like growth and for the EPRA NAV and 36% for the triple NAV).

### 4. Joint venture accounting and business combinations

Joint venture accounting, as with accounting for business combinations, is an area that is likely to change in future financial statements and therefore we have selected these topics in our survey.

The change proposed for joint venture accounting is that the proportional consolidation method will be eliminated and this will result in only one method, the application of equity method. Of the 30 (68%) entities that had joint ventures, 19 applied proportional consolidation. Sixteen of those 19 entities disclosed the impact of the change of joint venture accounting on their financial statements in future. This will result in a better solvency (4.23% relative) and in a decrease of the revenues in the comprehensive income statement (on average -7.04%).

Regarding business combinations the scope will be broader. Thirteen entities disclosed that they have made judgments on whether there have been business combinations or other acquisitions without disclosures of the criteria on which they have made that judgment.

### Conclusion

The main conclusions are:

- » More than 90% of the surveyed firms adopt the fair value model for IP
- » An improvement for IPUC is given by measuring those at fair value
- » Still 75% of the entities show negative fair value movements. The disclosures on uncertainties and on the risks should be improved
- » The uncertainties for determining the fair value have been increased without disclosures of this uncertainty. No disclosures for IP and IPUC separately while these have different risk profiles
- » Refinancing risks are disclosed in general terms without quantifying those disclosures
- » There are no disclosures of the criteria on the judgments for business combinations or other acquisitions

The following recommendations can be made:

- » Disclose the assumptions as well as the uncertainties relating to fair value of IP and IPUC, like vacancy rate, initial yield, discount rate, building risk and a maturity schedule for rentals
- » Be aware of breaching loan covenants and ensure timely refinancing. Furthermore, be transparent on the quantification of the loan covenants and the breach of those loan covenants as well as the waivers received eventually
- » Include more non-GAAP measures, like EPRA, in the director's report and/or financial statements but with reference to the rules of IFRS for those non-GAAP measures in the financial statements (include definition, statement that these are Non-GAAP measures and a reconciliation to the IFRS numbers)

*This article was printed with the permission of E&Y*

**Kees is Head of Professional Practice Department in RSM Netherlands**

**T: +31 (0)30 24 28 505  
E: kroozen@rsmnederland.nl**

## 2 The point of view of ...



**Jane Meade**

...on Revenue recognition - the latest developments

### Background

In Issues 1 and 6 of RSM Reporting we outlined the proposals, potential impacts and our thoughts on the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) joint exposure draft (ED) 2010/6 Revenue from Contracts with Customers. Since the December 2010 issue there has been significant discussion and redeliberation in this area. The ED was open to public comment up until 22 October 2010, during which period a total of 986 submissions were received. Such a huge amount of submissions from a wide variety of industries indicates that the proposals have stirred a great deal of interest among constituents and that the potential impacts are, as we expected, viewed as far-reaching. Interestingly, almost half of the responses were from preparers of financial statements and these respondents represented industries such as construction, manufacturing, telecommunications, technology, pharmaceuticals, biotechnology, financial services, consulting, entertainment, energy and franchising.

As discussed in Issue 6, the ED proposed the following process for recognising revenue:

1. Identify contract(s) with a customer
2. Identify the separate 'performance obligations' in the contract
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligations
5. Recognise the allocated revenue when the entity satisfies each performance obligation

### Issues Identified in Comment Letters

Whilst RSM International supported the overall framework and the move toward convergence between US GAAP and IFRS, which has been both a long running and challenging process, there were some areas that we thought needed some further guidance or amendment. Our views were consistent with many of the submissions from other organisations. Some of the points we raised in our submission were:

#### Segmentation of Contracts

The ED proposed that where the price of some goods or services in the contract is independent of the price of others, the contract would be accounted for as two or more contracts. We submitted that this would cause unnecessary complexity to address an issue that would not be that common in practice.

#### Transfer of Control

We raised our concern that guidance on when the transfer of control of a promised good or service is recognised is insufficient. Transfer of control is one of the cornerstones of the proposed standard particularly for service transactions and long-term construction contracts.

#### Consistent Application

Concerns were raised that the proposals could be difficult to apply consistently across a wide range of industries and could therefore produce accounting outcomes inconsistent with the economic substance of an entity's contracts with its customers. As a result, costs could be imposed on preparers in excess of the benefits of having a single revenue recognition model applying equally to all contracts with customers.

#### Retrospective Application

The proposed principles would require full retrospective application which we outlined would be overly burdensome for preparers.

### Redeliberation process

The issues around segmentation of contracts and transfer of control were the two key issues identified by the boards for redeliberation. Other issues also identified for redeliberation include:

- » Transaction price and variable consideration
- » Credit risk
- » Time value of money
- » Onerous contracts
- » Transaction costs
- » Disclosure
- » Application guidance
- » Transition

Since the redeliberations commenced in January 2011, there have been several meetings and a number of tentative decisions made. However, these could be subject to further change in the future.

Some of the significant decisions made since redeliberations began are:

### 1. Segmenting a contract

The boards have now proposed eliminating the requirement in the ED, described above, to account for one contract as two or more contracts. Consequently, an entity would separate a contract only if the entity identifies separate performance obligations in the contract.

### 2. Combining contracts

The boards have tentatively decided that two or more contracts could be combined into a single contract if they are entered into with the same customer at or near the same time and either:

- » The contracts are negotiated as a package with a single commercial objective,
- » The amount of consideration in one contract depends on the other contract, or
- » The goods and services in the contracts are interrelated in terms of design, technology or function.

### 3. Identifying separate performance obligations

The ED proposed that a performance obligation is a promise to transfer a distinct good or service. While this concept is to be retained, it has been refined to consider cases, such as those relating to construction contracts, where bundles of goods and services are highly interrelated. In these cases, the entity often provides a significant service of integrating those goods and services into the single item that the customer has contracted for. These bundles of goods and services would be accounted for as a single performance obligation.

In addition, the criteria for determining whether goods or services are distinct have been refined. A good or service will be distinct if the underlying goods or services are transferred in a pattern that differs from the pattern of transfer of other goods or services in the contract and either:

- » The entity regularly sells the good or service separately, or
- » The customer can use the good or service either on its own or together with resources that are readily available to the customer.

### 4. Determining the transfer of goods and services

The boards have reaffirmed the core principle in the ED that an entity should recognise revenue to depict the transfer of goods and services to a customer.

#### Goods

The boards have decided that revenue recognition for goods should be based on a customer obtaining control of the good. It has also been decided that most of the guidance on control in the ED will be retained and control will continue to be described rather than defined. In terms of indicators of control, the boards intend to add 'risks and rewards of ownership' and eliminate 'the design or function of the good or service is customer-specific' as indicators of control.

#### Services

The ED did not propose specific guidance regarding the transfer of services to customers. The boards have tentatively decided that to recognise service revenue, an entity must determine that a performance obligation is satisfied continuously. This will be determined to have occurred if either:

- » The entity's performance creates or enhances an asset that the customer controls, or
- » the entity's performance does not create an asset with an alternative use to the entity and one of the following is true:
  - » the customer receives a benefit as the entity performs each task, or
  - » the task would not need to be re-performed by another entity who is to fulfil the remaining obligation, or
  - » the entity has a right to payment for performance to date.

#### Goods and services

Where both goods and services are to be transferred, the entity will be required to determine whether the goods and services are distinct (in accordance with the guidance on identifying separate performance obligations).

If the goods and services are distinct, the entity would account for them as separate performance obligations. If the goods and services are not distinct, the entity would account for the bundle of non-distinct goods and services as a service.

In this way, it is now suggested that for most construction contracts, revenue will be recognised over the term of a contract in accordance with the pattern of transfer of goods and services. Further clarification around input and output methods provided in the ED is expected.

### 5. Warranties

The ED distinguished two types of warranty - latent defect and insurance. Both would be accounted for as 'deferred revenue' at inception of the contract. It has been agreed that some warranties will now be accounted for as a cost accrual in accordance with IAS 37 Provisions, Contingent Liabilities and Contingent Assets.

If a customer has the option to purchase a warranty separately from the entity, the entity should account for the warranty as a separate performance obligation and would allocate revenue to the warranty service. However, the warranty would be accounted for as a cost accrual if the customer does not have the option to purchase a warranty separately and the warranty only provides assurance that the entity's past performance was as specified in the contract.

In summary, we welcome the decisions made to date as part of the redeliberation process. While further redeliberation will continue, the boards have indicated that they still intend to issue the final standard in 2011. The effective date is still to be confirmed.

**Jane is National Technical Director in  
RSM Bird Cameron, Australia**

**T: + 61 2 8226 9518**

**E: jane.meade@rsmi.com.au**

## 2 The point of view of ...



### Olga Panchenko

#### ...on IFRS 10 Consolidated Financial Statements and IFRS 12 Disclosure of Interests in Other Entities

New changes to IFRSs regarding Consolidation in terms of presentation of the entity's and its subsidiaries' (and other entities under its control) financial position and performance results and cash flows will definitely influence the process of understanding and making appropriate decisions by users of consolidated financial statements.

At the time of preparing this article the IASB was very close to publishing its new standards on consolidation - IFRS 10 Consolidated Financial Statements IFRS 10 and IFRS 12 Disclosure of Interests in Other Entities and three amending standards, which combined will replace IAS 27 Consolidated and Separate Financial Statements (IAS 27) and SIC-12 Consolidation - Special purpose entities.

It is expected that the forthcoming IFRS 10 will not change consolidation procedures as they were stipulated by IAS 27, but rather establish the principles to be applied to determine whether an investor controls an investee and therefore must consolidate an investee's accounts.

#### History of the project

The project on Consolidation was added by the IASB to its agenda in June 2002, when it was decided to eliminate divergence in practical application of the guidance in IAS 27 and SIC-12. The purpose of the project was to develop a single, common, comprehensive, principles-based standard on consolidation founded on a consistent basis for determining when an investor consolidates an investee's accounts irrespective of the nature of the investee, and thus to make the financial statements of groups more comparable and understandable.

In April 2008, in response to the global financial crisis and the recommendation of the Financial Stability Forum, the IASB decided to accelerate the consolidation project and to address disclosure requirements relating to off balance sheet entities. The ED was published in December 2008.

#### New definitions of control

The ED proposed the following definition of control of an entity: A reporting entity controls another entity when the reporting entity has **the power to direct** the activities of that other entity to generate returns for the reporting entity.

The new definition of control differs from the control concept in IAS 27 as far as IAS 27 defines control as the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities. SIC-12 places greater emphasis on risks and rewards, and thus prioritises quantitative assessment of whether the investor has the majority of risks, which practically proved to create more structuring opportunities.

In September 2010, the IASB presented its Staff Draft (SD) IFRS X Consolidated Financial Statements with its cumulative tentative decisions made with consideration of all comments received to the specified date. In this preliminary version of the new standard on consolidation, the definition of control has been amended, compared to the ED, and some terms were replaced by new terms. Thus, 'reporting entity' was replaced by 'investor', 'subsidiary' and 'structured entity' were replaced by the single term 'investee'.

According to the SD the primary consideration for determining which entities to consolidate is that of **"the power to control"**. The IASB has tentatively decided that a reporting entity (investor) controls another entity (investee) when it is exposed, or has rights, to variable returns from its involvement with an investee and has the ability to affect those returns through its power over the investee.

An investor has power over an investee when it has existing rights that give it the current ability to direct the activities that significantly affect the entity's returns.

An investor can have power over an investee by different means:

- » By having the ability to direct the investee's relevant activities, which can arise from (i) having more than half of the voting rights in the investee or (ii) contractual rights, within other contractual arrangements, that relate to the investee's relevant activities (iii) or a combination of voting and contractual rights
- » By holding less than half of the voting rights in an investee considering relevant facts and circumstances

#### The assessment of whether an investor has power over an investee

The assessment of whether the investor has power over the investee includes an assessment of both the **investor's rights** (and whether they are sufficient to give the investor power), and whether **the**

**rights held by other parties could prevent the investor from having power**. Considering that only one entity can control another entity, preventing rights<sup>15</sup> could be an indicator when assessing power to control.

In the situations when an investor does not have the contractual ability to direct the activities (e.g. when it holds less than half of the voting rights in an investee), it may need to rely on other evidence of indicators of power to probe the ability to direct, such as whether it can obtain additional voting rights from holding potential voting rights or whether the investee's operations are dependent on the investor. In some situations, considering the size of the investor's voting rights relative to the size and dispersion of holdings of other vote holders, could provide sufficient evidence that an investor has, or does not have, power. When two or more investors have existing rights that provide ability to direct different activities, the investor that has the current ability to direct the activities with most significant effect on returns has power over the investee.

#### Power and return elements of the control definition.

At the October 2009 joint meeting, the IASB and the FASB agreed to conduct their respective consolidation projects jointly, and from January to July 2010, the boards discussed the project jointly. The IASB and the FASB (hereinafter the boards) tentatively decided that:

- » An investor that holds more than half of the voting rights in the investee meets the **power element** of the control definition, in the absence of other arrangements
- » An investor (with less than half of the voting rights in an investee) that has the legal or contractual ability to direct those activities of the investee that significantly affect the returns meets the **power element** of the control definition

In the case of an investor that has less than half of the voting rights, the IASB provides further guidance on how to consider facts and circumstances to conclude on an ability to direct the activities that significantly affect the investee's returns.

The FASB decided in January 2011 that it would not change the consolidation requirements relating to voting interest entities at this time. The FASB did, however, tentatively decide that it would propose changes to the consolidation requirements relating to variable

interest entities in the context of assessing whether a decision-maker is a principal or an agent. Those proposals would be similar to the proposed requirements developed jointly by the IASB and the FASB regarding the principal agent assessment, which will be included in the IASB's forthcoming consolidation standard.

The boards tentatively decided that potential rights (options, convertible instruments) and other factors associated with them constitute facts and circumstances that should be considered when assessing whether an investor has the power to direct the activities of the investee.

The IASB tentatively decided to clarify that 'the activities' in the control definition are those activities of an investee that significantly affect the investee's returns, and that requirements regarding the **returns element** of the control definition are as follows:

- » An investor must be exposed, or have rights, to variability of returns in the future
- » An investor's returns can have the potential to be wholly positive, wholly negative or either positive or negative (and this was the reason why the term 'benefits' in IAS 27 was replaced by 'returns' in the ED)

Hence, the **returns element** of the control definition is consistent with the concept of exposure to risks and rewards. As far as exposure to risks and rewards alone does not determine that the investor has control over an investee, and risks and power are not necessarily correlated, this exposure forms a substantive part of control.

#### Other facts and circumstances to be considered

Among other facts and circumstances to be considered when assessing control over an investee, the IASB tentatively decided to indicate an understanding of the purpose and design of an entity (e.g. the way decisions on relevant activities are made and how these activities will affect returns may provide evidence of who has power to control) and reputational risk that relates to the risk that failure of an investee would damage an investee's reputation, compelling the investor to provide support to the investee in

<sup>15</sup> Editor's note: also referred to as veto rights

## 2 The point of view of ...

order to protect the reputation of the investor, even though the investor has no legal or contractual reasons to do so. Reputational risk is not in itself an indicator of control and is not an appropriate basis for consolidation, but is a part of an investor's exposure to risk and rewards and should be a factor to consider along with other facts and circumstances. In other terms, it is not an indicator of power in its own right, but may increase an investor's incentive to secure rights that give an investor the power to direct the activities of an investee.

### Continuous assessment of control

The IASB tentatively concluded that a reporting entity should be required to assess control continuously because relevant facts and circumstances to be considered may change.

### Disclosures

Regarding disclosures, the IASB tentatively decided the following:

- » To combine the disclosure requirements for subsidiaries, joint ventures, associates and unconsolidated structured entities within a comprehensive disclosure standard IFRS 12 that would address a reporting entity's interests in other entities, including the disclosure requirements for joint operations
- » To enhance disclosure of all significant judgments and assumptions in determining whether or not the reporting entity controls another entity and any changes in its control assessments that require significant judgement

Among other disclosure requirements, it was tentatively decided to clarify the characteristics of information that will be useful to the users of financial information as the following:

- » Composition of the group
- » Interests that non-controlling interests have in a group's assets and cash flows
- » Nature and effect of all significant restrictions on its ability to access and use assets of the group, and settle its liabilities etc.
- » Nature of, and changes in, the risks associated with its interest in consolidated structured entities

Besides the information concerning the group, the new standard is expected to require disclosure of information about unconsolidated structured entities. The IASB tentatively decided that general

disclosure objectives regarding unconsolidated structured entities will be to:

- » Present information about the nature and extent of a reporting entity's interests in unconsolidated entities by presenting their income and assets information in the case of a reporting entity that sponsors the entity but there is no transaction between them
- » Enable users to evaluate the nature and changes of risks associated with involvement with a structured entity

### Further developments

The five forthcoming IFRSs on consolidations and joint arrangements are as follows: IFRS 10, IFRS 11 Joint Arrangements, IFRS 12, Revised IAS 28 Investments in Associates and Joint Ventures and Revised IAS 27 Separate Financial Statements.

The effective date of the forthcoming IFRSs (which were expected to be issued by the end of Q1/2011) will be 1 January 2013, with early application permitted only if all five IFRSs are applied at the same time. On transition to IFRS 10 and IFRS 11, limited retrospective application will be required.

During the years of financial turmoil and its consequences, the sale of assets to other entities has become quite wide spread among financial institutions. This is due to a variety of purposes, one of which being to clear the statement of financial position from bad assets. Financial institutions and entities that perform certain functions for financial institutions are quite often jointly controlled by the parent company. Accordingly, if the parent company prepares consolidated financial statements, it includes figures of each participant of the group and, normally, is not affected by the movements of assets within the group.

There are some situations, however, when, according to IAS 27 (and these conditions seem to remain substantially unchanged under the new IFRS 10), financial institutions, being public entities, are required to prepare consolidated statements at the level of entities under their own control. Then, the question arises as to the existence of control over the entities which perform certain functions for financial institutions.

According to the SD regulations, a financial institution would have to analyse purpose and design, reputational risk and other facts and circumstances when assessing control over the entity and, therefore, the need to include their figures in consolidated financial statements.

While a parent company can be the main provider of capital to the entity with certain functions, the financial company can give significant technical and / or operational support to the entity. Thus, most of the technical issues of servicing debts and further sale of assets of the company are solved by involvement of former staff from the financial institution, considering their skills and experience. Besides, major operational and financial decisions could be directed to the financial institution's benefit.

At the same time, when transactions on loan debts sale from a financial institution to the entity can be considered as transactions between related parties, which are the entities under common control, these transactions could be completely in line with financial assets derecognition criteria under IAS 39, i.e. (i) assets can be transferred together with collateral, (ii) there are no requirements to provide evidence for the future involvement of this financial institution in settlements for these loans, (iii) there are no repayments for loans, acquired by the entity.

This raises the following question: shall the financial company that is obliged to prepare consolidated financial statements (i.e. being public and in a process of filing to the securities commission or other regulative bodies for issuance of any kind of debt or equity instrument) consolidate its financial statements with those of separate entities, to which assets were sold, even if they were created by the parent company and are consolidated on the highest level? Who effects the decisions on activities which significantly affect returns of special purpose entities? Consideration should be given to the fact that it is quite difficult to determine fair value and market conditions for transactions when there is no active market in place.

It is expected that the new standards give guidance on how to define who has the power to control the entity. However, there is still the risk of some issues being left outside the scope. For example, in the situations described above, will it be sufficient for the users to have such transactions disclosed as if they were related parties' transactions rather than provide them with a full disclosure of the financial effect on assets and liabilities and performance results, as a consequence of transactions with the entity, which in fact serves to the financial institution more than to the parent company of the group currently and probably in the future?

**Olga is an Audit and Tax Partner in RSM APiK,  
Ukraine Certified Auditor, ACCA member**

**T: + 380 (44) 501 59 34**

**E: [olga.panchenko@apik.com.ua](mailto:olga.panchenko@apik.com.ua)**

# 3 Top Ten Topics in IFRS



**Joelle Moughanni**  
Hedging

In December 2010, the IASB published an exposure draft on hedge accounting (the comment period closed on 9 March 2011). The proposed future requirements (expected in H2/2011 effective for periods beginning on or after 1 January 2013) will be incorporated into IFRS 9 Financial Instruments, replacing the rule-based and restrictive hedge accounting requirements in IAS 39 and more closely aligning the accounting with risk management activities.

Entities engage in hedging activities to mitigate the impact of economic risks on their performance (this can range from as simple as borrowing in a foreign currency where an entity has an anticipated revenue stream in that currency to much more complex hedging strategies). Only valid economic hedging strategies that meet strict criteria qualify for the special hedge accounting of IAS 39. Such hedge accounting modifies the usual accounting treatment of a hedging instrument and/or a hedged item to enable gains and losses on the hedging instrument to be recognised in the income statement in the same period as offsetting losses and gains on the hedged item.

Meanwhile, despite being criticised for not appropriately reflecting risk management, being complex and confusing (distinction between fair value and cash flow hedges) and being arbitrary and too rule-based (high hurdles for a hedging relationship to qualify for hedge accounting such as effectiveness testing), the current hedge accounting requirements of IAS 39 still apply and continue to raise implementation challenges. This article addresses the key questions of such challenges.

## First key question: when is hedge accounting applied?

Hedge accounting is an exception to the usual accounting principles for financial instruments. If an entity's management chooses to apply hedge accounting, they must identify, document and test the effectiveness of those transactions for which they wish to use hedge accounting. Hedge relationships are required to meet certain criteria in order to qualify for hedge accounting under IAS 39, the specific requirements being the following:

- » The hedging relationship must be formally designated and documented at the inception of the hedge. This must include identifying and documenting the risk management objective, the hedged item, the hedging instrument, the nature of the risk being hedged and how the effectiveness of the hedge will be assessed
- » The hedge must be expected to be highly effective at its inception

## 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 ✓

- » The effectiveness of the hedge must be tested regularly throughout its life. Effectiveness must fall within a range of 80%-125% over the life of the hedge (thus leaving some scope for small amounts of ineffectiveness, provided that overall effectiveness falls within this range)
- » In the case of a hedge of a forecast transaction, the forecast transaction must be 'highly probable'

These criteria for hedge accounting are onerous and have systems implications for all entities. As hedge accounting is optional, management should consider the costs and benefits when deciding whether to use it. In practice, much of the burden and cost associated with using hedge accounting arises from the effectiveness testing requirements.

**Table 1 - Hedged items**

Key Items and risks	Qualifying as hedged item for hedge accounting purposes?	Comments
Net position	No	However, similar effect achievable by designating the hedged item as part of one of the gross positions (i.e. as one or more individual assets, liabilities or forecast transactions equal in amount to the net position).
Held-to-maturity investments for interest rate risk	No	However, may be designated as a hedged item with respect to foreign exchange and credit risk.
Forecast purchase of an item of property, plant and equipment (PPE) denominated in a foreign currency	Yes (if highly probable and all conditions for hedge accounting are met)	Hedged item in a cash flow hedge of foreign currency risk (movements in exchange rates will affect the amount paid for the purchase and thus profit or loss as the PPE is depreciated).
Portfolio of individually small receivables denominated in the same currency	Yes	Fair value movements of each individual item attributable to the hedged risk are expected to be approximately proportional to the fair value movements of the group of assets that are attributable to the hedged risk.
Portfolio of different available-for-sale equity investments for equity price risk	No	Changes in individual prices are not approximately proportional to the overall change in the fair value of the portfolio (some share prices may increase and others may decrease).
An entity's own shares	No	Purchase, sale, issue or cancellation of treasury shares do not affect profit or loss (recorded in equity).
Intra-group receivables or payables between entities with different functional currencies (in consolidated financial statements)	Yes	Receivables / payables give rise to an exposure to foreign currency gains or losses that is not fully eliminated on consolidation.
Equity investment in a foreign subsidiary, associate or joint venture (in parent's separate financial statements)	Yes	Fair value hedge of the currency risk associated with the shares, if designation of a clear and identifiable exposure to changes in foreign exchange rates in the shares held.
Forecast sales where individual sales transactions cannot be tracked	Yes	Designated hedged item could be the first X foreign currency units of highly probable cash flows in specific time buckets (e.g. each quarter).

Cont'd >

# 3 Top Ten Topics in IFRS

Table 2 - Hedging instruments		
Key Items and risks	Qualifying as hedging instrument to achieve hedge accounting?	Comments
Inter-company loan or internal derivative at group level	No	Only instruments involving a party external to the group can be designated as a hedging instrument.
Borrowing in one currency as a hedge of a net investment in another currency	Yes (if effectiveness achieved)	There must be high correlation between the two currencies (e.g. they are formally pegged to each other). In practice, effectiveness rarely achieved unless the currencies are perfectly correlated.
Combination of derivative and non-derivative instruments	Yes (if the derivative is not a written option)	The non-derivative can be used to only hedge foreign currency exposure.
Pre-existing derivative (having been held for some time)	Yes	Hedge accounting for the derivative is applied from the inception of the new qualifying hedge relationship.
Proportion of a derivative	Yes	For example, 70% of a forward contract designated as the hedging instrument. However, only a portion of the remaining life of a derivative cannot be designated as a hedging instrument.
Written option	No	Neither on its own nor in combination with other derivatives (unless it is designated as an offset to a purchased option). No written option is effective in reducing the exposure of a hedged item.
Created collar by a purchased call option and a sold put option with different counterparties	No	A collar can only be designated as a hedging instrument if the purchased and written options are combined in a single instrument and the collar is not a net written option (i.e. no net premium is received). This could have been the case if the two instruments had the same counterparty and are entered into simultaneously, and in contemplation of one another with the intent of creating a collar; they could be viewed then as one transaction.

## Second key question: what are the hedge effectiveness testing requirements?

IAS 39 requires two kinds of effectiveness tests that both need to be met for hedge accounting to be available:

- » A prospective effectiveness test - A forward-looking test of whether a hedging relationship is expected to be highly effective in future periods. It is required at the inception of the hedge and at the time an entity prepares its interim or annual financial statements
- » A retrospective effectiveness test - A backward-looking test of whether a hedging relationship has actually been highly effective in a past period. It is required at the time an entity prepares its interim or annual financial statements

A hedge is regarded as highly effective only if both of the following conditions are met:

- » At the inception of the hedge, and in subsequent periods, the hedge is expected to be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated (prospective effectiveness test)
- » The actual results of the hedge are within a range of 80%-125% (retrospective effectiveness test)

Hedge ineffectiveness can arise for a number of reasons, such as when the hedged item and the hedging instrument are in different currencies, have different maturities, use different underlying interest or equity indices, use commodity prices in different markets, are subject to different counter-party risks, etc. Hedge effectiveness can often be improved by careful designation of the hedge relationship (e.g. designating the hedged item as a portion of an asset or liability or excluding the time value from a hedge relationship using an option).

## Third key question: is it necessary to do a quantitative hedge effectiveness test when the principal terms of the hedging instrument match those of the hedged item?

By virtue of example, Hedgy Plc enters into a three-year fixed-rate borrowing. On the same date, it enters into a receive-fixed/pay-floating interest rate swap on which the floating leg is reset every three months. The principal terms of the swap and the debt match (start date, end date, fixed payment dates, calendar basis, principal amount, fixed interest rate), and there are no features or conditions that would invalidate an assumption of perfect effectiveness.

### a. Prospective effectiveness test

No, Hedgy Plc can perform only a qualitative prospective effectiveness test in order to demonstrate that the hedge is expected to be highly effective. In fact, the fixed leg of the swap exactly matches the interest payments on the hedged fixed-rate debt and the floating-rate leg is not likely to give rise to material ineffectiveness (given the short interval between the re-pricing dates).

### b. Retrospective effectiveness test

Yes, Hedgy Plc must determine that the hedge actually has been highly effective throughout the financial reporting period for which it was designated. Even if the principal terms of the hedging instrument match those of the hedged item, ineffectiveness may still arise (if the floating rate leg is not reset on the testing date, if there is a change in the liquidity of the swap or in the creditworthiness of the swap counterparty, etc.).

## Fourth key question: can a hedge relationship that fails a retrospective test be re-designated for the next period if the prospective test is successful?

Yes. If a designated hedge relationship fails the retrospective test for a given period, hedge accounting should be discontinued. However, if a successful prospective effectiveness test is performed with the same hedging instrument and the same hedged item at the start of the following period, the hedge relationship can be re-designated for the remaining life of the instrument.

## Fifth key question: can credit risk be excluded from the measurement of effectiveness in an interest-rate hedge?

Yes. An entity can designate any portion of risk in a financial asset or liability as the hedged item. Hedge effectiveness is generally significantly easier to achieve if the designated hedged risk matches the hedging instrument as closely as possible. Sometimes, the entity should re-designate the risk being hedged in order to improve the hedge effectiveness for future periods. For example, if the entity's deteriorating creditworthiness is the major cause of the hedge ineffectiveness in an interest-rate hedge of an issued bond, management should exclude this risk going forward and hedge only the changes in the bond's fair value attributable to changes in the risk-free interest rate.

# 3 Top Ten Topics in IFRS

**Sixth key question: in a hedge of the forecast acquisition of a non-financial asset (or forecast issuance of a non-financial liability), can the hedging gain or loss that is initially recognised in equity be included in the carrying amount of the acquired asset (or the issued liability)?**

Yes. In fact, the entity has the choice of the accounting policy to apply consistently to all hedges of a forecast transaction that will result in the recognition of a non-financial asset or non-financial liability between:

(a) including the hedging gain/loss previously deferred in equity in the initial carrying amount of the non-financial asset or non-financial liability (basis adjustment). The hedging gain/loss will affect the income statement when the hedged item is depreciated or sold, and

(b) leaving the hedging gain/loss in equity until it is transferred to the income statement when the hedged item affects profit or loss.

**Seventh key question: how should a hedging relationship be formally designated and documented?**

To qualify for hedge accounting, an entity must (amongst other conditions) formally designate and document a hedge relationship between a qualifying hedging instrument and a qualifying hedged item at the inception of the hedge. The following illustration could be easily used as a template for such documentation:

## Hedgy Plc's Hedge Documentation

### 1) Risk management objective and strategy

For the current period, Hedgy Plc's approved strategy in accordance with its risk management policies is to maintain a ratio of fixed:floating rate net debt of between 40:60 and 50:50. In order to achieve this ratio, management has selected this debt to be swapped from fixed to floating.

### 2) Type of hedging relationship

Fair value hedge: swap of fixed to floating interest rates.

### 3) Nature of risk being hedged

Interest rate risk: change in the fair value of debt number XXXX attributable to movements in the GBP LIBOR zero coupon curve. Credit risk on the debt is not designated as being hedged.

### 4) Identification of hedged item

Transaction number: reference number XXXX in the treasury management system.

The hedged item is a five-year, GBP 15m, 6% fixed rate debt, which pays interest quarterly.

### 5) Identification of hedging instrument

Transaction number: reference number YYYY in the treasury management system.

The hedging instrument is a five-year interest rate swap, notional value GBP 15m, under which fixed interest of 5% is received quarterly and actual three-month LIBOR is paid with a three-month reset.

### 6) Hedge designation

The fair value movements on the full notional GBP 15m of the swap YYYY is designated as a hedge of fair value movements in the debt XXXX attributable to movements in GBP LIBOR zero coupon curve.

### 7) Effectiveness testing

Testing shall be performed using hedging effectiveness testing strategy 1B in the effectiveness testing policy.

#### Description of prospective test

Dollar offset method, being the ratio of the change in the clean fair value of the swap YYYY, divided by the change in clean fair value of the bond XXXX attributable to changes in GBP LIBOR zero coupon curve.

The critical terms of the swap do not perfectly match the critical terms of the hedged debt. The prospective tests will therefore, as required by the risk management policies, be performed based on three scenarios.

Frequency of testing: at inception of the hedge and at each reporting date (30 June and 31 December).

**Joelle Moughanni is a Technical Manager in the RSM International Executive Office**  
**T: + 44 (0)207 601 1089**  
**E: joelle.moughanni@rsmi.com**

## Touching base two years on

Our first edition was published in the summer of 2009. This is a brief account of the highlights and the guest contributors who have shared their expertise with us.



### In Issue 1:

- » Financial Assets and Fair Value\*
- » Revenue Recognition
- » Income Tax

\*Guest contributor  
 Paul Klumpes, Professor at Imperial College, London



### In Issue 2:

- » Financial Statement Presentation\*
- » Defined Benefit Pension
- » Borrowing Costs
- » Leases

\*Guest contributor  
 Denise Gomez Soto, Project Manager at IASB



### In Issue 3:

- » Comprehensive Income\*
- » Audit Impairment Test
- » Liability Measurement

\*Guest contributor  
 Francesco Bellandi, writer



### In Issue 4:

- » Globalisation of IAS/IFRS\*
- » Business Combinations and Consolidation
- » Carbon Trading Scheme

\*Guest contributor  
 Mike Wells, Education Initiative Leader at IASB



### In Issue 5:

- » IFRS for SME\*
- » Financial Assets and Fair Value
- » Financial Statements and Valuations

\*Guest contributors  
 Michael Izza and Marianne Mau, CEO and Technical Manager at ICAEW



### In Issue 6:

- » Governance and Accountability\*
- » IASB Agenda
- » Revenue Recognition

\*Guest contributor  
 Mike Brooks, writer



### In Issue 7:

- » Financial Statement Presentation\*
- » Financial Assets and Fair Value
- » Income Tax
- » Management Commentary

\*Guest contributors  
 Chris Chapman, Professor at Imperial College, London

## Global Contacts

### Americas

Bob Dohrer  
T: +1 919 645 6819  
E: robert.dohrer@mcgladrey.com

### Europe

C.M. (Kees) Roozen  
T: +31 (0)30 24 28 505  
E: kroozen@rsmnederland.nl

### Asia Pacific

Jane Meade  
T: +61 2 8226 9518  
E: jane.meade@rsmi.com.au

### Middle East

Chandra Sekaran  
T: +965 2245 2680  
E: chandra.sekaran@albazie.com

### Africa

Simon Fisher  
T: +254 20 4451747/8/9  
E: sfisher@ke.rsmashvir.com

### RSM Global Executive Office - UK

Ellen Costa  
T: +44 (0)20 7601 1080  
E: ellen.costa@rsmi.com

Dr Marco Mongiello ACA  
Director MSc Management and MSc Innovation & Entrepreneurship  
Principal Teaching Fellow in Accounting  
Imperial College Business School  
T: +44 (0)20 7594 9686  
E: m.mongiello@imperial.ac.uk

The publication is not intended to provide specific business or investment advice. No responsibility for any errors or omissions nor loss occasioned to any person or organisation acting or refraining from acting as a result of any material in this publication can be accepted by the authors or RSM International. All opinions expressed are those of the authors and not necessarily that of RSM International. You should take specific independent advice before making any business or investment decision.

RSM International is the brand used by a network of independent accounting and consulting firms. Each member of the network is a legally separate and independent firm. The brand is owned by RSM International Association. The network is managed by RSM International Limited. Neither RSM International Limited nor RSM International Association provide accounting or consulting services. The network using the brand RSM International is not itself a separate legal entity of any description in any jurisdiction. RSM International Limited is a company registered in England and Wales (company number 4040598) whose registered office is at 11 Old Jewry, London EC2R 8DU. Intellectual property rights used by members of the network including the trademark RSM International are owned by RSM International Association, an association governed by articles 60 et seq of the Civil Code of Switzerland whose seat is in Zug. © RSM International Association, 2011