



Key IFRS accounting developments affecting asset managers and funds

As at 14 May 2010

Contents

Introduction	2
IFRS 9: <i>Financial Instruments</i> (IAS 39 replacement)	2
Classification and measurement of financial assets	3
Classification and measurement of financial liabilities	4
Financial instruments: amortised cost and impairment	5
Hedge accounting	6
Derecognition	7
Consolidation	8
Financial instruments with characteristics of equity	10
Fair value measurement	11
Financial statement presentation	12
Non-financial liabilities	13
Revenue recognition	15
IFRS for SMEs	16



Introduction

Numerous financial reporting issues have arisen from the global financial crisis, with the spotlight on the accounting for financial instruments. The International Accounting Standards Board (IASB) has responded by accelerating its project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and amend or replace several other standards. Inevitably, asset managers and funds will be significantly affected by the IAS 39 replacement project and a number of other accounting developments, including those relating to financial instruments with the characteristics of equity, fair value measurement, financial statement presentation, and consolidation. This document provides an overview of certain recent IFRS accounting developments as at 14 May 2010 and their potential impact on funds.

The accounting developments in this publication are compiled from final standards and exposure drafts issued by the IASB, as well as tentative decisions that have been made by the IASB at subsequent meetings.

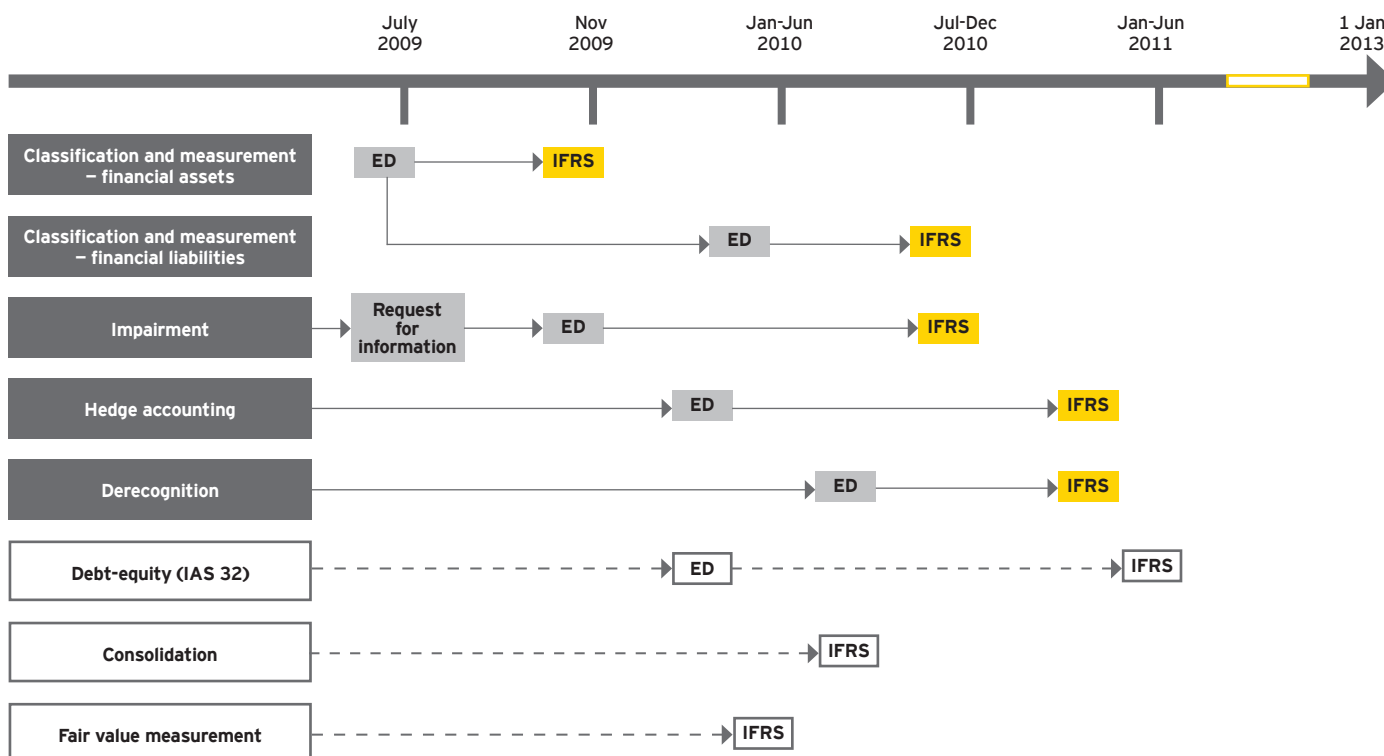
IFRS 9 *Financial Instruments* (IAS 39 replacement)

IAS 39 has been widely criticised for being complex and often difficult to apply. In April 2009, the G-20 leaders, the Financial Stability Board, and various stakeholders urged the IASB and the US Financial Accounting Standards Board (FASB) (together, the Boards) to reduce the complexity of accounting standards for financial instruments and make significant progress towards a single set of high quality global accounting standards.

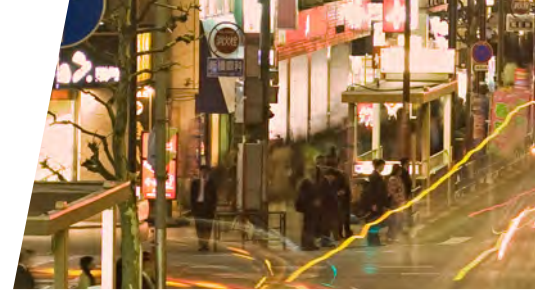
In order to expedite the replacement of IAS 39, the IASB divided the project into phases. In November 2009, the IASB published the first phase of IFRS 9 *Financial Instruments*, which focuses on the classification and measurement of financial assets. The IASB's work on the other phases is currently ongoing, and includes financial liabilities, impairment of financial instruments, hedge accounting, and derecognition.

The aim is to replace IAS 39 in its entirety by the end of 2010 (see timeline below). As each phase is completed, chapters with the new requirements will be added to IFRS 9, and the relevant portions deleted from IAS 39.

Financial instruments – timeline

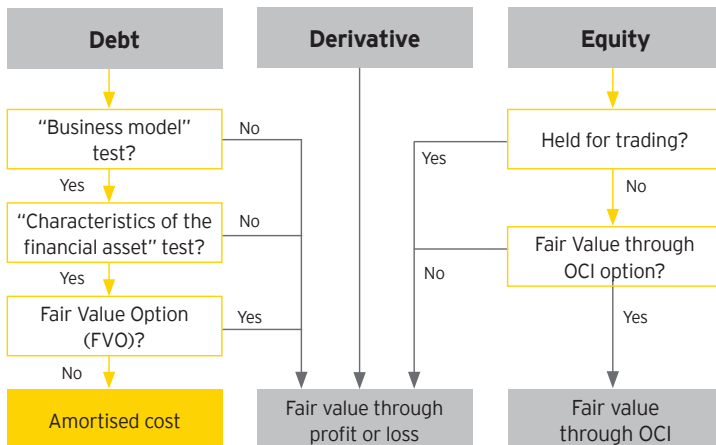


Key: ED/IFRS: Exposure draft/standard is expected.



Classification and measurement of financial assets

An overview



Source: Ernst & Young

Debt instruments

Financial assets that are non-derivative debt instruments (including loans) may be measured at amortised cost subsequent to initial recognition if:

- ▶ The asset is held within a business model whose objective is to hold the assets to collect the contractual cash flows (the 'business model' test)

and

- ▶ The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal outstanding (the 'characteristics of the financial asset' test).

However, a debt instrument eligible for measurement at amortised cost can be measured at fair value through profit or loss if the entity elects to apply the fair value option in order to eliminate an accounting mismatch. All other debt instruments are measured at fair value through profit or loss.

Equity investments

Equity investments are measured at fair value through profit or loss, except that IFRS 9 allows an option to designate non-trading equity investments at fair value through other comprehensive income (OCI) upon initial recognition. The designation is irrevocable.

Fair value changes in such investments are recognised in OCI, with no recycling of gains and losses to profit or loss on impairment or on sale of the investment. The standard requires that dividends received from investments measured at fair value through OCI be recognised in profit or loss, unless they represent a recovery of part of the cost of the investment.

There is no restriction as to the type of equity investments eligible for designation through OCI, as long as they meet the definition of equity (as currently set out in IAS 32) and are not held for trading. Accordingly, equity derivatives cannot be designated at fair value through OCI.

Effective date and transition

The mandatory effective date for IFRS 9 is 1 January 2013, with early adoption permitted once approved in the local jurisdiction. The standard is not yet available to European entities, as the European Commission has not yet endorsed it.

IFRS 9 must be applied retrospectively. However, the assessment of whether instruments are to be measured at amortised cost or fair value will need to be made for those instruments on the entity's statement of financial position as at the initial application date and based on facts and circumstances at that date. Comparative periods need not be restated if the standard is applied for reporting periods beginning before 1 January 2012.

Potential impact

The impact is not expected to be significant as funds primarily account for their investments at fair value through profit or loss. Compared with IAS 39, IFRS 9 has fewer classification and measurement categories for financial assets and it eliminates the complex, rule-based requirements for separating embedded derivatives, the tainting rules for held-to-maturity investments and the difficulties in determining impairment for available for sale (AFS) assets.

Funds that adopt IFRS 9 and have AFS investments which would now meet the criteria for amortised cost, or fair value through OCI, may not need to record the full fair value decline as impairment as they currently do under IAS 39. Adoption of the new standard also gives an opportunity to re-visit previous fair value option elections.

The effects of applying the new standard will differ from one fund to another. In some cases, there will be benefit in adopting the new standard prior to the mandatory application date. Funds need to assess the operational implications of the new accounting requirements. For example, there will need to be changes to systems and processes, to calculate and record changes in fair value or of effective interest and impairment, along with adjustments to the IFRS 7 disclosures. Meanwhile, portfolios of financial instruments may need to be subdivided to better reflect the business model. Certain funds may also need to consider the impact on regulatory capital and tax.

Ernst & Young publications

Supplement to *IFRS outlook* issue 60 (November 2009): IASB publishes IFRS 9: Phase 1 of new standard to replace IAS 39.



Classification and measurement of financial liabilities

Overview

The exposure draft (ED) *Financial Instruments: Classification and Measurement* issued in July 2009 proposed a two measurement category approach for both financial assets and financial liabilities – fair value and amortised cost. Many of the constituents who responded to the ED did not favour a fundamental change to the current requirements of IAS 39 for measuring financial liabilities because 'practice was working well', and the separation of embedded derivatives (so that the debt host is measured at amortised cost) substantially avoided the issue of recognising changes in own credit risk. After significant deliberation on how to address the issue of own credit risk, the IASB published a new ED in May 2010.

The ED proposes to retain the existing classification and measurement requirements in IAS 39 for financial liabilities, with two exceptions:

- ▶ The effects of changes in own credit risk will not affect profit or loss for financial liabilities designated at fair value through profit or loss (the fair value option 'FVO')

and

- ▶ Liabilities arising from derivatives on investments in unquoted equity instruments will no longer be measured at cost.

Where an entity chooses to measure financial liabilities at fair value through profit or loss using the FVO:

- ▶ The fair value will be recognised on the balance sheet, and the full change in fair value will be recognised in the income statement

and

- ▶ That portion of the change in fair value relating to the entity's own credit risk will be transferred from the income statement to OCI. Upon derecognition of the liability, amounts recognised in OCI will be transferred to retained earnings (instead of being recycled to profit or loss).

Under IAS 39, the FVO can be chosen for financial liabilities if the instrument meets one of three following criteria:

- ▶ Contains an embedded derivative
- ▶ Is managed on a fair value basis

or

- ▶ Would otherwise qualify for amortised cost measurement, but an accounting mismatch could arise if it is not measured at fair value

All of these criteria will be retained under IFRS 9 for using the FVO for financial liabilities.

It is expected that the new proposals will be mandatory for annual periods beginning on or after 1 January 2013. Early application may possibly be permitted if the entity also applies the previously finalised requirements of IFRS 9 on classification and measurement of financial assets.

Potential impact

The accounting for most financial liabilities will not change – those held for trading and free-standing derivatives will remain at fair value through profit or loss. Any financial liabilities recorded at amortised cost will remain so and any embedded derivatives that have in the past been separated and recorded at fair value through profit or loss will also continue to be accounted as such.

The proposal will possibly result in asymmetry between the accounting for financial assets compared with financial liabilities. Meanwhile, much of the complexity of the current rules for separating embedded derivatives under IAS 39 will continue under the new standard for financial liabilities.

However, the proposal will find favour with regulators who have always disliked the recognition of gains and losses due to changes in own credit risk for liabilities designated at fair value through profit or loss.

Timing

Comments on the ED are due by 16 July 2010. The final standard is to be issued during the first quarter of 2011.

Ernst & Young publications

Supplement to *IFRS outlook* issue 72 (May 2010): Classification and measurement of financial liabilities – new IASB proposals.

Financial instruments: amortised cost and impairment

Overview

In November 2009, the IASB published an Exposure Draft (ED) on *Financial Instruments: Amortised Cost and Impairment*.

The ED applies to all financial assets recorded at amortised cost in accordance with the first phase of the financial instruments project – IFRS 9 *Financial Instruments*. The ED addresses the calculation of amortised cost and the computation of the effective interest rate. This is largely a restatement of the principles in IAS 39. The ED also proposes an impairment methodology based on expected cash flows, including credit losses, for all financial assets measured at amortised cost.

The ED proposes that impairment losses are recognised over the life of the financial asset, by including expected losses in the computation of the effective interest rate when the asset is first recognised. Subsequent changes in credit loss expectations are reflected immediately in catch-up adjustments to profit or loss.

According to the ED, adoption would be retrospective, by adjusting the effective interest rate to approximate the rate that would have been determined at inception as if the entity had always used the expected cash flows approach.

The ED proposes extensive new qualitative and quantitative disclosures to enable users to understand the evolution of loan loss provisions, as well as providing information on the credit quality of financial assets.

The effective date is expected to be three years from the issue of the final standard (probably for periods commencing on or after 1 January 2014), since a longer-than-normal period will be necessary to allow preparers to modify their systems and collect the data required to estimate expected cash flows.

The IASB has established an Expert Advisory Panel (EAP), consisting of preparers of financial statements and credit risk professionals, as well as auditors and regulators, who meet monthly until June 2010 to address the operational challenges, provide application guidance, facilitate field testing and identify simplifications to the expected cash flows approach.

The FASB has, separately, been discussing changes to its existing 'incurred loss model', and plans to expose its new proposed impairment approach for comments in May 2010. It is expected that the FASB's new impairment approach will be a refinement of the current incurred loss model. Meanwhile, in March 2010, the European Banking Federation made public its proposal for an alternative impairment methodology. Among other differences, it proposes that the effect of changes in credit loss expectations should be spread prospectively over the remaining lives of the assets, rather than recorded immediately in profit or loss, while incurred losses are fully provided for as they arise.

Potential impact

Funds that measure their investments at fair value will not be impacted by the ED. But funds that have investments at amortised cost will be impacted. Estimating the amount and timing of cash flows over the entire lives of financial assets will require significant new processes and controls to be introduced and changes to key performance indicators and procedures for impairment assessment. Significant judgment will be needed in assessing expected future credit losses and changes in expectations will result in greater volatility in recorded profit or loss.

Timing

Comments on the ED are due by 30 June 2010. The IASB plans to publish a final standard in the second half of 2010.

Ernst & Young publications

Supplement to *IFRS outlook* issue 61 (November 2009): New proposals for financial instruments at amortised cost.



Hedge accounting

Overview

Given that the IASB has retained a mixed-measurement model for financial instruments (amortised cost and fair value), some form of hedge accounting will continue to be needed. The hedge accounting requirements in IAS 39 are considered complex and, whilst there are some underlying principles, there are also many detailed rules – such as the quantitative criteria for assessing hedge effectiveness (within a range of 80-125%) – that are often considered as unnecessary.

Therefore, as part of its project to replace IAS 39, the IASB is also addressing hedge accounting. The hope is that the new hedge accounting model will be based on high level principles that are better aligned with risk management, in order to provide information that is both relevant and can be more easily understood by users.

To date, the IASB has tentatively decided to simplify today's fair value hedge accounting by replacing it with an approach that is similar to cash flow hedge accounting. This would involve recognising outside of profit or loss (i.e., in OCI) the effective portion of gains and losses on financial instruments designated as hedging instruments. The two approaches would continue to differ in that the existing 'lower of' test as required in IAS 39 would continue to remain for cash flow hedges (for cash flow hedges the equity is adjusted for the lower of the gain or loss on the hedging instrument or the change in fair value of hedged item), but will not be extended to fair value hedge accounting. It has also tentatively been confirmed that financial instruments managed on a contractual cash flows basis will be eligible hedged items for a fair value hedge.

The IASB is currently exploring bifurcation-by-risk for financial and non-financial items – i.e., whether entities would be permitted to choose to apply hedge accounting to particular risks, rather than all of the risks pertaining to the hedged item.

The IASB's work on this phase of the project is still far from complete – there are a number of issues that will need to be addressed – including how eligible hedged items should be identified, whether effectiveness testing should allow a qualitative approach and what requirements should be in place for dedesignation and discontinuation. Besides, any new approach should involve principles that are equally applicable to non-financial hedged items.

In developing the new standard, the IASB plans first to address the general hedging model, including whether groups of assets or liabilities can be treated as a single hedged item, and then consider the implications for portfolio (or macro) hedge accounting.

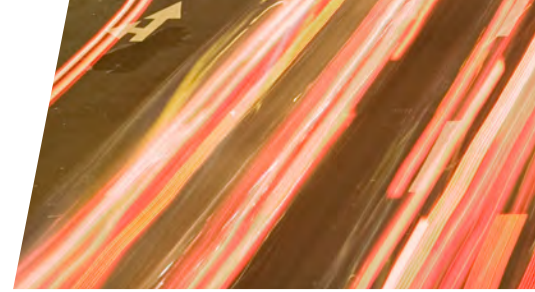
Potential impact

The number of funds applying hedge accounting is limited, with many funds employing economic hedging strategies instead. Under the current IAS 39 hedge accounting requirements, preparers face a number of challenges with respect to designation, documentation, measurement and effectiveness testing. Consistent feedback from users of financial statements is that current hedge accounting is relatively complex and difficult to understand. Instead, users expect that hedge accounting should reflect the risk management strategies adopted by the entity.

Therefore, any simplifications of the current hedge accounting requirements may be a welcome change – although the exact details of these changes will only emerge in the months to come.

Timing

An exposure draft is expected to be issued during the second or third quarter of 2010 and a final standard is expected in the first quarter of 2011.



Derecognition

Overview

Together with the FASB, the IASB is in the midst of a project to improve and simplify the derecognition requirements for financial instruments. In March 2009, the IASB published an ED which included an approach based on control and sketched out an alternative approach.

Based on the feedback received, in October 2009, the IASB decided to further develop the alternative approach. Its principle is that a financial asset is derecognised when the transferor does not have present access, for its own benefit, to all of the cash flows or other economic benefits of the transferred asset.

Under this approach, when the rights to any identified cash flows are transferred, the transferor derecognises the previously recognised asset and recognises new assets and liabilities, at fair value, for the rights and obligations either retained or obtained in the transaction.

For example, consider the sale of a floating rate bond to a third party where, as part of the sale, the seller writes a put option. The option obliges the seller to repurchase those cash flows if the buyer decides to exercise the option and sell back the bond. However, until the buyer exercises that right, the seller does not have present access to those cash flows. Hence, the seller derecognises the bond and recognises the option at fair value.

However, the IASB has tentatively decided that most sale and repurchase agreements (repos) and similar transactions will not be subject to the derecognition criteria for financial assets and will continue to be accounted for as secured borrowing.

In addition, the financial asset derecognition criteria cannot be applied to financial instruments that can be both an asset or a liability over their life, such as an interest rate swap, unless the counterparty to the instrument has expressly consented to the novation of the liability.

Meanwhile, a financial liability is derecognised when it no longer qualifies as a liability of the entity, that is when the present obligation is eliminated and a transfer of economic resources is no longer required.

Potential impact

The new approach is simpler than the existing derecognition requirements and, in particular, removes the need for accounting for the 'continuing involvement'. However, disclosures of the 'continuing involvement' may still be required.

A key point to note is that an entity could be required to derecognise a financial asset even when it retains substantially all the risks and rewards. As a result, it is likely that financial assets will more often be derecognised by the transferor, resulting in the recognition of fair value gains and losses. It is also important to note that the change in the derecognition requirements may have an impact on the application of phase 1 of IFRS 9, as it may be difficult to claim that the objective of a business model is to hold assets to collect principal and interest, if those assets are derecognised.

The disclosures proposed in the ED to demonstrate the risks the entity is exposed to from its continuing involvement in the transferred assets are onerous and their production will require the modification of management information systems and internal controls.

Timing

An ED was published in March 2009, and the comment deadline for it ended on 31 July 2009. Following the IASB's decision to forge ahead with the alternative approach in the ED, the IASB has now completed development of the new model. The IASB's plan is to expose the new approach in June or sometime during the third quarter of this year with a final standard expected in the first quarter of 2011.

Ernst & Young publications

IFRS outlook (May 2010).



Consolidation

Overview

The IASB has been engaged in a project to develop a single, comprehensive standard on consolidated financial statements, which will apply to all entities. The new standard will replace the consolidation requirements of IAS 27 *Consolidated and Separate Financial Statements* and SIC-12 *Consolidation-Special Purpose Entities*. In December 2008, the IASB published an ED entitled *Consolidation* and, in October 2009, the IASB agreed with the FASB to conduct their respective consolidation projects jointly.

An entity must consolidate in its financial statements all entities that it controls. Control, as currently defined in this project, is the power of a reporting entity to direct the activities of another entity to generate returns for that reporting entity.

Power is assessed based on current facts and circumstances; it need not necessarily be exercised, nor does it need to be absolute. Power is the current ability of a reporting entity to direct the activities of another entity that significantly affect the returns to the reporting entity. Exposure to risks and rewards and involvement in the design of an entity are indicators of control, but in isolation, are not a sufficient basis on which to conclude that there is control.

Investment companies, such as mutual funds, private equity funds, venture capital funds and hedge funds, may be excluded from the consolidation requirements of the proposed standard. To be an 'investment company,' an entity must meet several criteria:

- ▶ *Express business purpose*
The express business purpose of an investment company is investing for current income, capital appreciation, or both.
- ▶ *Exit strategy*
The entity has identified potential exit strategies and a defined time (or range of dates) at which it expects to exit the investment.
- ▶ *Investment activity*
Substantially all of the entity's activities are investment activities carried out for the purposes of generating current income, capital appreciation, or both. The entity and its affiliates shall not obtain benefits from its investees that would be unavailable to other investors or unrelated parties of the investee.
- ▶ *Unit ownership*
Ownership in the entity is represented by units of investments.
- ▶ *Pooling of funds*
The funds of the entity's owners are pooled so that owners can avail themselves collectively of professional investment management.

- ▶ *Fair value*
All of the investments are managed, and their performance is evaluated (both internally and externally), on a fair value basis.
- ▶ *Reporting entity*
The entity must be a reporting entity.

If finalised, an investment company meeting the above criteria, will be required to measure its investments in other entities that it controls at fair value through profit or loss, rather than consolidating such controlled entities. When the investment company has a parent, such as when it is owned by a bank, unless the parent is also an 'investment company', the parent does not retain the investment company's accounting (that is, the parent would consolidate the investment company and its controlled investments).

It is proposed that investment companies that measure controlled investments at fair value through profit or loss will be required to present the following disclosures:

- ▶ Any financial or other support provided to controlled investments that the investment company was not previously contractually required to provide.
- ▶ The nature and extent of any significant restrictions on the ability of the controlled investees to transfer funds to the investment company.
- ▶ A schedule of investments including information about the investment's type, industry, country or geographic region.
- ▶ A financial highlights schedule in the notes to the financial statements (similar to that required by US GAAP). This schedule would include: per share investment income or loss, realised and unrealised gains and losses per share, distributions to shareholders, purchase premiums, redemption fees, payments by affiliates; expense, net investment income and total return ratios, and capital commitments.

A reporting entity may have the power to direct the activities of another entity even when it holds less than half of the voting rights of that entity. A reporting entity may also have power over another entity through holding options or convertible voting rights in an entity. The final standard will also list several factors to consider when assessing whether the reporting entity is an agent or a principal in wielding its power when acting, for instance, as a fund manager: (1) its decision-making authority; (2) rights held by other parties (e.g., kick-out rights); (3) its remuneration; and (4) its exposure to variability of returns.

The Boards have distinguished between 'participating rights' and 'protective rights'. Participating rights are those that give the reporting entity the right to direct (or veto) the operating and financing policies (decisions made in the ordinary course of business) of another entity. If a participating right can be exercised by only one party (that is, without agreement of others), a participating right gives control to that reporting entity. The right to remove another party (e.g., a 'kick-out right') may also be a participating right. However, the more parties that must agree to the exercise of a participating right, the less likely it is that those rights are substantive, and the less likely that those rights prevent another party from having power. If a right is limited to vetoing fundamental changes in another entity, that right is a 'protective right' and does not give power, nor does it prohibit another party from having control over that other entity.

In some situations, such as the case for many structured entities (SE), power is not determined by voting rights and the activities of the SE or fund are pre-determined. In such cases, an assessment of control is made based on whether the reporting entity has power over the activities that significantly affect the returns of that fund or SE. The intention of the Boards is that the control principles within the new standard will produce consolidation results consistent with those reached for SEs under current US GAAP.

Potential impact

Depending on how the proposals are finalised, particularly those relating to the definition of an investment company, and the nature of the reporting entity's arrangements, the adoption of the new standard is likely to have a significant effect on the entities that need to be consolidated. For many asset managers and other structures that manage a fund and also have a direct interest in that fund (i.e., a dual role), careful consideration will be required to assess whether it acts as a principal (and therefore may need to consolidate the fund) or as an agent (and recognises only its direct interest and the management fee). For structured entities, the activities that affect returns will need to be determined, as well as which entity has the power over those activities. The biggest impact on the consolidation of SEs is likely to be where they were structured primarily to reflect the indicators in SIC 12 of who has 'the majority' of the risks and rewards.

Timing

After completing deliberations in the second quarter of 2010, the IASB will re-expose decisions regarding the investment company scope exceptions and will make a staff draft of its proposed final standard available. The FASB will also produce an ED covering areas where the new standard differs from current US GAAP. They plan to issue a final converged standard on consolidation by the end of 2010. The IASB plans to issue a final standard on the disclosure requirements for unconsolidated structured entities in the third quarter of 2010.

Ernst & Young publications

IFRS outlook (May 2009).

IFRS outlook (March 2010).



Financial instruments with characteristics of equity

Overview

The objective of this joint FASB and IASB project is to improve and simplify the financial reporting requirements for financial instruments with the characteristics of equity.

After discussing several different approaches, in March 2010, the Boards decided to commence drafting an ED on financial instruments with the characteristics of equity, based on IAS 32 *Financial Instruments: Presentation*. Significant changes based on the Boards tentative decisions include the following:

- ▶ Changes to the treatment of puttable instruments and instruments issued by entities with specified lives, such that a greater proportion of such instruments would be classified as equity.
- ▶ Other puttable instruments, e.g., investment fund units, will be separated into liability and equity components. The liability component is a derivative, (a written put option) measured at fair value through profit or loss, with the equity component being the residual. If the instrument is redeemable at fair value, the written put option has minimal value, and the carrying amount of the equity component approximates the value of the puttable instrument. If the instrument is redeemable at Net Asset Value (NAV), the written put option may have a more significant value. This is due to NAV not necessarily being equal to fair value.
- ▶ As an additional requirement, for a contract to issue shares to be classified as equity, the shares must already be authorised.
- ▶ There may be a gain or loss recorded in profit or loss on conversion of convertible debt.
- ▶ Transaction costs on the issue of equity instruments would be expensed in profit or loss rather than being deducted from equity.
- ▶ There are new proposed disclosures for all entities and a supplemental schedule of the fair value of issued equity instruments and long-term debt for public entities.

Potential impact

The Boards' proposals to amend IAS 32 are intended to address some of the issues that arise in practice, with the result that more instruments are likely to be classified as equity. Entities will, however, need to carefully evaluate the final proposals to determine the financial, legal and regulatory impact, including the effect on results and financial ratios and compliance with any covenants or capital requirements; in addition they will need to understand the effects on business process and information systems to implement the proposals.

For those funds whose instruments are redeemable at NAV which is different to a NAV calculated in accordance with IFRS, careful consideration will need to be made of the potential bifurcation of the instrument into debt and equity portions and how such messages are communicated to the stakeholders. The requirement to expense transaction costs may also have an impact of the performance of funds when instruments are issued.

Timing

An ED is expected in the second quarter of 2010, with a four-month comment period. The IASB expects to publish a new standard in the first half of 2011.

Ernst & Young publications

IFRS outlook (April 2010).



Fair value measurement

Overview

Currently, the guidance on 'how to' measure fair value is distributed across many IFRSs and it is not always consistent, resulting in complexity and diversity in practice. In September 2006, the FASB issued *Fair Value Measurements*. In October 2008, the IASB's Expert Advisory Panel (EAP) on fair value measurement issued guidance on determining fair values in illiquid markets for financial instruments. In May 2009, the IASB issued an exposure draft *Fair Value Measurement*, which is largely consistent with existing US GAAP. The objectives of the project are to:

- ▶ Establish a single source of guidance for all fair value measurements
- ▶ Clarify the definition of fair value and related guidance
- ▶ Enhance disclosures about fair value measurements
- ▶ Increase convergence between IFRS and US GAAP

Potential impact

The last of the above mentioned objectives is a predominant theme in the project. In response to constituent feedback reiterating the need for consistent guidance to determine fair value measurements, the IASB and FASB decided to make this a joint project. However, differences may remain between IFRS and US GAAP, particularly where the Boards perceive that the difference is 'when' to measure fair value, and not 'how' to measure it, which is the main focus of this project. For example, one major difference relates to day one gains and losses. US GAAP permits recognition of day one gains and losses for financial instruments, without a reliability threshold, whereas IFRS prohibits recognition for financial instruments unless the fair value is based on quoted active market prices. The IASB and the FASB recognise that this is an issue, but it has yet to be addressed.

Other implications of the current proposals include:

- ▶ Blockage factors (i.e., a reduction in the price of a financial instrument if a market participant sells a large holding) are prohibited at any level of the fair value hierarchy.

- ▶ Entities may use mid prices as a basis for establishing fair values for offsetting market risk positions, and may consider credit adjustments on a net basis, if certain criteria are met.
- ▶ The IASB decided not to grant a practical expedient for measuring fair value of alternative investments (e.g., investments in hedge funds, private equity funds, and real estate funds) based on their net asset value, because of the difficulties in creating definitions that could be applied internationally. This will remain a difference between IFRS and US GAAP.
- ▶ The disclosure requirements may be burdensome for preparers. IFRS 7 currently requires an entity to disclose the effect of changing one or more of the inputs to reasonably possible alternative assumptions for level 3 instruments which are recorded at fair value in the financial statements. The IASB is now proposing to require a sensitivity analysis for all level 3 measurements (unless another standard specifically exempts such measurements), regardless of whether they are for a financial instrument, even for fair values that are only disclosed in the notes to the financial statements and this sensitivity analysis must explicitly consider the effect of correlation between inputs, when relevant.

Timing

The IASB has stated that it expects to release a final converged standard in the third quarter of 2010.

Ernst & Young publications

Supplement to *IFRS outlook* issue 43 (June 2009): Fair value measurement – proposals for a new standard, *IFRS outlook* (November 2009), *IFRS outlook* (April 2010).



Financial statement presentation

Overview

The Financial Statement Presentation project (FSP project) was initiated as a joint project between the IASB and FASB in 2004 and it was split into three phases. Phase A was finalised in 2007 which resulted in an amendment to IAS 1 and is already effective. Phase A introduced, amongst other changes, a separate presentation of owner and non-owner changes in equity, the concept of other comprehensive income and the requirement for an additional balance sheet in cases of retrospective amendments to an entity's financial statements. Phase B was initiated with a discussion paper in October 2008. The Boards finalised their deliberations in April 2010 and will soon issue an exposure draft. Phase C will be focussed on interim reporting.

The objective of Phase B is to ensure that the information presented in the financial statements is relevant to the user by requiring cohesiveness and a greater level of disaggregation in a manner that it is useful in predicting an entity's future cash flows.

Expected changes

The statements of financial position, comprehensive income and cash flows will be classified into separate *Business* and *Finance* sections, whereby the *Business* Section consists of *Operating activities, Investing activities and Finance arising from operating activities*, whereas the *Finance* section will be divided into *Debt and Equity*. It is envisaged that applying this classification throughout these statements will enhance presentation and comparability of transactions.

Entities will continue to be permitted to disaggregate their statement of comprehensive income by nature if that provides users with more useful information. The existing presentation for financial institutions (i.e., interest income, interest expense, etc.) will remain and the only change will be the requirement to segregate according to the defined sections and categories. The Boards intend to remove the option to present the statement of comprehensive income in two separate statements. However, the distinction between profit or loss and other comprehensive income will remain.

In respect of the statement of cash flows, the Boards intend to require the use of the direct method while requiring a separate note disclosure showing operating cash flows using the indirect method. Presenting cash flows under the direct method will require presentation of actual cash flows of an entity's operations, rather than subtracting non-cash movements from an entity's net profit. In addition, financial institutions will be required to present cash flows for loans made to customers and principal collections of gross loans rather than net loans.

The Boards will also require an analysis of each significant asset and liability line item, i.e., to disaggregate the movements in the significant accounts into separate types of transactions (changes due to cash inflows and outflows, routine non-cash transactions such as depreciation and changes in provisions, and non-routine non-cash transactions such as impairment of goodwill and re-measurements).

Finally, the ED will require an analysis and separate note disclosure of the effect of re-measurements on the statement of comprehensive income. Re-measurements reflect the effect on profit or loss arising from the change in the net carrying amount of an asset or liability due to a change in a current or estimated price or value or the method to compute the carrying amount of the asset or liability.

Potential impact

The proposal requires all entities to classify the balance sheet using the defined sections and categories. The amendment, however, will continue to permit a presentation of the balance sheet in order of liquidity. Consequently, funds will still be allowed to use this presentation. The only change is that they will be required to split the balance sheet into the *Business* and *Finance* sections and their respective categories. Once this split is determined, they can then present the individual balance sheet line items in order of liquidity within their respective categories.

While the split between the *Business* and *Finance* sections should be relatively straightforward, the challenge will arise in determining the respective categories (i.e., *Operating* and *Investing*). This is because the segregation will need to be determined based on how a fund's business model works and how it manages its assets and liabilities. Management's intention as to how it will realise an asset or settle a liability will not be relevant in determining this split.

Also, capturing the relevant information for the analysis of changes in significant balance sheet line items and the effect of re-measurements may prove to be an onerous exercise.

The requirement for a direct method cash flow statement means that preparers will need to identify and classify cash movements appropriately while the disaggregation requirement will result in enhanced disclosure. Many funds still prepare the cash flow statement using the indirect method. Consequently, they may need to improve their underlying IT systems by creating additional information tools if the existing systems are unable to provide the required information and data.

Timing

An exposure draft is expected in the second quarter of 2010.

Non-financial liabilities

Overview

The IASB has issued a working draft of the standard that is to be issued as an IFRS to replace IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

Scope

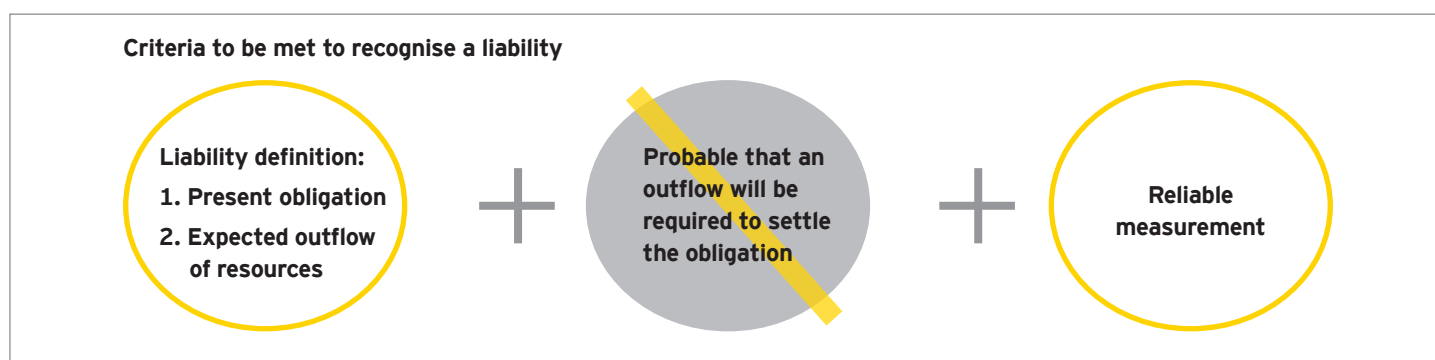
All liabilities, except those that are accounted for under another IFRS (e.g., IAS 39 *Financial Instruments: Recognition and Measurement*) or those resulting from non-onerous executory contracts, are included in scope of the working draft.

Financial instruments not measured at fair value through profit or loss, such as certain financial guarantee contracts and loan commitments, may be subject to this standard for subsequent measurement purposes only, while loan commitments may be in

the scope of the entire standard if they become onerous. However, the final scope of IFRS 9 and reconsideration of the subsequent measurement requirements for loan commitment liabilities and financial guarantee contracts may be discussed by the IASB in the future phases of the IAS 39 replacement project.

Recognition

IAS 37's recognition provisions have been amended to remove the requirement that it must be probable – more likely than not – that an outflow will be required to settle the obligation in order to recognise a liability. Removal of this criterion focuses attention on the definition of a liability in the *Framework* – a **present obligation** of an entity arising from past events, the settlement of which is **expected to result in an outflow from the entity of resources embodying economic benefits**. This change is depicted in the diagram below.



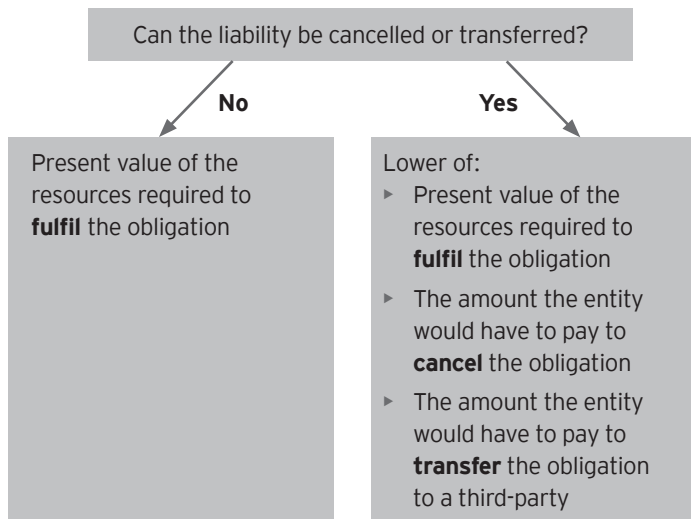
In most cases, removal of the probable criterion will not yield different results from current practice because an entity will still need to determine whether a present obligation exists.

In other cases, such as in a legal dispute, it is often difficult to determine whether there is a present obligation. For example, before a dispute is finalised, it is not always clear whether the claim is valid and there is a present obligation. Additionally, management and their advisors typically do not provide a definitive statement that a claim has no merit. In these cases, it will be impossible to make an unreserved judgment that there is no valid claim.

The proposals drive an entity to a binary position – is there, on balance, a present obligation? There is no place for the answer “there may be”. So the new proposals may give rise to more situations where disputes are recognised as liabilities.

Measurement

The working draft proposes that a liability within the scope of the new standard should be measured at the amount that the entity would rationally pay to be relieved of the liability. This amount is dependent on whether or not the liability can be cancelled or transferred, as illustrated in the flowchart on the following page.



If the outflow of resources required to **fulfil** the obligation is uncertain, the entity would estimate their expected present value, determined using market rates. This is the probability-weighted average of the outflows for the range of possible outcomes, adjusted for the risk that the actual outflow of resources might ultimately differ from those expected. The risk adjustment measures the amount, if any, the entity would rationally pay in excess of the expected present value of the outflows to be relieved of this risk. Loan commitment liabilities and financial guarantee contracts in scope of the proposed measurements would ordinarily be measured on this basis.

If the liability is to undertake a service at a future date (including services the entity will undertake itself), the outflows would be the amounts that the entity estimates it would pay a contractor at the future date to undertake the service on its behalf (including the profit margin of a contractor).

The amount that an entity would have to pay to **cancel** or **transfer** an obligation is the price the counterparty or a third party would demand, plus any costs of cancellation or transfer.

Potential impact

The changes to the recognition criterion may result in additional liabilities being recognised for obligations which previously did not meet IAS 37's recognition threshold. Previously, these may not have been deemed a probable outflow of economic resources (e.g., obligations in a legal dispute when management believes that there is a present obligation due to the evidence available to them, but the probability of any payment being required to settle the obligation is less than 50 per cent).

The proposed measurement requirements for liabilities will likely require significant new processes to be introduced and changes to the information systems to capture more information. Entities will

have to obtain evidence of the range of possible outcomes and their probabilities. This may be a timely and costly exercise for some entities.

The use of expected outcomes or cash flows may result in changes to the timing and the amount recognised for loan commitment liabilities and financial guarantee contracts.

As the final amount recognised for the liability to be fulfilled will no longer represent possible outflows but a probability-weighted average of possible outflows, further disclosure to the shareholders may ultimately be required to explain how the amount was determined.

Proposed changes to IAS 37 may impact how entities account for tax uncertainties. Many entities using IFRS currently look to IAS 37 as a model for their uncertain tax positions (UTPs) absent guidance in IAS 12 *Income Tax*, so any changes to IAS 37 could mean a re-assessment of how they calculate their UTPs.

At their November 2009 meeting, the IASB staff indicated a desire to ensure future IAS 12 guidance on UTPs is consistent with what is eventually prescribed in IAS 37. In fact, the meeting papers indicated the IASB would need to consider whether any future proposals on UTPs are consistent with IAS 37 and it would also need to "justify any inconsistencies". As such, changes to IAS 37 could be an early indicator of eventual changes to IAS 12.

Provisions and uncertainties for non-income based tax liabilities (such as many value-added taxes), have always come within the scope of IAS 37 rather than IAS 12, so any changes to IAS 37 would impact how those non-income based taxes are accounted for.

The new standard is likely to have a significant effect on the financial position of many entities. For some, liabilities may be recognised earlier and at higher amounts than they are today. For other entities, it may result in a reduction in the overall value of liabilities. All entities will need to carefully evaluate the effect of this on financial ratios and debt covenant compliance.

Timing

The working draft does not indicate an effective date for the final standard. The transitional provisions in the 2005 ED required no restatement of comparative information.

The IASB's project plan indicates that the final standard is expected to be issued in the third quarter of 2010. Although not specific to this project, the IASB tentatively decided, in its December 2009 meeting, that major projects completed in 2010 should not become effective earlier than for annual periods beginning on or after 1 January 2012.

Ernst & Young publications

Supplement to *IFRS outlook* issue 65 (January 2010): Proposals to change the measurement of non-financial liabilities. *Searching for clarity in uncertain tax positions* (February 2010).



Revenue recognition

Overview

In June 2010, the IASB and FASB plan to issue an ED *Revenue Recognition – Revenue from Contracts with Customers*. The ED will propose a new, joint standard for revenue recognition which will replace IAS 18 *Revenue*, IFRIC 13 *Customer Loyalty Programmes* and other revenue standards. Applying the underlying principle proposed by the Boards, an entity would recognise revenue when it satisfies its performance obligations in a contract by transferring goods and services to a customer.

The Boards have decided that contractual rights and contractual obligations currently within the scope of IAS 39/IFRS 9 are excluded from the scope of the proposals. Hence, there will be no change in the revenue recognition for financial instruments within the scope of IAS 39/IFRS9. However, transactions currently accounted for under the requirements of IAS 18 and IFRIC 13 will fall within the scope of the ED.

Potential impact

This will impact the revenue recognition of various fees earned by entities in the financial sector, where these fees are not within the scope of IAS 39/IFRS9. In addition, performance fees, which represent a significant source of revenue for asset managers, are also likely to be affected. Currently, these fees are recognised either upfront or over time, as required by IAS 18.

Under the proposed model, the critical issues for asset managers to consider are:

- ▶ Estimation of the fees to be charged
- ▶ The performance obligations related to fees that are charged
- ▶ The manner of allocation of these fees to the different performance obligations
- ▶ Given that the new model recognises revenue based on the transfer of control to the customer, at what point does control of the service pass to the customer?

Entities will need to consider if the proposed model results in decision-useful information. As the proposed model has the potential to significantly change revenue recognition practices, entities should not miss the opportunity to provide comments to the Boards.

Timing

The Boards expect to issue the ED in June 2010, and a final IFRS to be issued in the second quarter of 2011.

Ernst & Young publications

Supplement to *IFRS outlook* issue 24 (December 2008): Revenue recognition project preliminary views.

Revenue recognition project: IFRS preliminary views (June 2009).



IFRS for SMEs

Overview

The IASB's stated objective in creating *IFRS for Small and Medium-sized Entities* (SMEs) is to create information from the 'specific perspective of a SME' that would assist a broad range of users in making economic decisions. The financial statements should also reflect the stewardship function of management. In order to achieve this goal, the IASB designed a standard for SMEs that is based on, but stands alone and is distinct from, 'full' IFRS.

Can a fund apply IFRS for SMEs?

IFRS for SMEs defines a SME and provides guidance regarding the entities to which the standard applies.

"Small and medium-sized entities are entities that:

- ▶ Do not have public accountability
- and
- ▶ Publish general purpose financial statements for external users."

The definition of an SME refers, firstly, to the fact that these entities produce general-purpose financial statements for their external users, and, secondly, they do not have any public accountability.

Whilst, for many entities, this definition provides a clear answer as to whether the standard can be applied, for some entities, significant judgment is required to determine whether the entity is within the scope of the standard. Some jurisdictions may further define what a SME is, but it is important to note that such changes can only restrict the current scope (and not extend it to non-SMEs). Such restrictions may assist the determination of whether an entity is within the scope or not.

Does a fund have public accountability?

The definition of 'public accountability', given in the Glossary to *IFRS for SMEs* (shown in box 1), begins with a broad definition of 'accountability' followed by specific criteria to determine whether an entity has 'public accountability'.

In applying this, funds need to address the following key factors:

- ▶ **Are its debt or equity instruments traded in a public market?**
Public markets bring together buyers and sellers in arms length transactions. Accordingly, regardless of size, funds whose securities are traded in a public market are required to provide full IFRS general purpose financial statements to their investors and other users for decision making purposes.
- ▶ **Does the fund hold assets in a fiduciary capacity? Is there a broad group of outsiders? Is this part of the fund's primary business?**
The primary business of funds such as mutual funds, is to hold and manage financial resources for a broad group of members who are not involved in the fund's management. The basis for conclusions (paragraphs 56 and 59) make specific reference to funds. Because such funds act in a public fiduciary capacity, they are publicly accountable and cannot apply *IFRS for SMEs*.

Box 1: Public accountability definition

Accountability to those existing and potential resource providers, and others external to the entity, who make economic decisions, but are not in a position to demand reports tailored to meet their particular information needs. An entity has public accountability if:

- ▶ Its debt or equity instruments are traded in a public market or it is in the process of issuing such instruments for trading in a public market (a domestic or foreign stock exchange or an over-the-counter market, including local and regional markets)

or

- ▶ It holds assets in a fiduciary capacity for a broad group of outsiders as one of its primary businesses. This is typically the case for banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks

Potential impact

Funds will first need to address whether they are within scope of *IFRS for SMEs*. For traded funds this assessment is easy – there is no such option. For other funds, the situation can get more complex and require judgment based on the specific facts and circumstances.

SMEs are not required to use the standard. The IASB intended that the standard could be used by SMEs and that such financial statements must claim compliance with the standard. If compliance with full IFRS is required, desired or preferred, the SME may continue using or adopt the full IFRS standards and need not adopt this standard. Additionally, regulators will often place reporting restrictions on funds in their jurisdiction.

Timing

The standard was issued on 9 July 2009, but it does not have an effective date of application. Therefore, the standard is considered immediately effective for any entity preparing financial statements on or after 9 July 2009 and wishing to apply the standard. However, caution is required and any such entity must consider the requirements of regulators and users in transitioning to the standard.

Ernst & Young publications

Talking SMEs publications (November 2009 and April 2010).



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