

RSM! Reporting

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

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Welcome from the Editor

Marco Mongiello

With its second edition, RSM Reporting formally becomes a sequel and carries on exploring some of the most topical current issues in international reporting, bringing you RSM members' experience from the field and the voice of other experts who are in privileged places of observation.

In this edition we host the personal contribution of Denise Gomez Soto, who draws her personal opinions from her role of Project Manager at IASB. She addresses the important matter of 'financial statement presentation', providing us with considerations on the comments received until April 2009, about the changes and developments of the very formats that reporting entities will be using in the years to come, when reporting their financial performance and situation.

Of more technical nature are the subsequent contributions in this edition. Marycken van Dijke comments on some examples of application of IFRIC 14 in large reporting entities. Her contribution refers to non-obvious effects of this IFRIC and their consequences, which are illustrated in a very simple and effective way.

Chandra Sekaran aims at 'touching base' on the matters related to borrowing costs. This is a matter where many ambiguities still persist and Chandra's views are clearly indicating thought-through recommended directions - with explanations!

David Talbot contributes to the debate on the developments on the treatment of leases. This is a debate that seems to be gaining more momentum after the deadline for comments has expired and David has his say on the matter, corroborating his point of view with some detailed illustrations.

Finally Stefano Bianchi carries on covering his Top Ten Topics. In this edition he addresses the challenges of how and when to derecognise financial instruments in connection with special purpose entities; a topic where the devil is indeed in the detail, as his explanations and examples show us.

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Marco Marcellan

IFRS for Small and Medium-sized Entities (SMEs)

Milestones

Objectives:

- > To establish a common, high-quality set of simplified IFRS requirements for entities with non-public accountability that issue general purpose financial statements.

Current status:

- > Final.

What's next:

- > IFRS for SMEs does not have an effective date. Each jurisdiction can determine its own effective date and could choose to use IFRS for SMEs immediately.
- > After an initial implementation review, the IASB expects to propose amendments to IFRS for SMEs by publishing an omnibus exposure draft approximately once every three years.
- > The IASB expects to undertake a thorough review of SMEs' experience in applying the IFRS for SMEs when two years of financial statements using the standard have been published by a broad range of entities.

At the beginning of July 2009 the International Accounting Standards Board (IASB) released IFRS for Small and Medium-sized Entities (SMEs). The project was carried forward from the former International Accounting Standards Committee (IASC) agenda and IASB deliberations began in July 2003.

In a nutshell, IFRS for SMEs is the result of the recognition of the fact that Full IFRS are tailored for the needs of listed companies and are too complex for SMEs.

As soon as IFRS for SMEs was released, Sir David Tweedie (IASB Chairman) commented as follows:

"The publication of IFRS for SMEs is a major breakthrough for companies throughout the world. For the first time, SMEs will have a common high quality and internationally respected set of accounting requirements. We believe the benefits will be felt in both developed and emerging economies".

IFRS for SMEs is a self contained set of standards of about 230 pages - compared to about 2800 pages of Full IFRS - that has been specifically designed in order to meet the needs of entities that do not have public accountability. Not "publicly accountable" entities represent the vast majority of all companies globally.

IFRS for SMEs is based on Full IFRS and retains the authority of Full IFRS but introduces significant simplifications compared to Full IFRS. IFRS for SMEs includes only one cross-reference to Full IFRS which relates to financial instruments.

IFRS for SMEs has been designed using a 50-employee typical entity guideline, not as a quantified size test for defining SMEs but rather to assist the IASB in determining the types of transactions that the standard should address. The standard may be suitable for even smaller entities.

IFRS for SMEs is not intended to be mandatory. It will be up to each individual jurisdiction to determine whether or not to adopt the standard and, if it is adopted, to what extent that should be the case.

The main simplifications can be categorised as follows:

- > some topics in Full IFRS are omitted because they are not relevant to typical SMEs
- > some accounting policy options in Full IFRS are not allowed because a more simplified method is available to SMEs
- > simplification of many of the recognition and measurement principles that are in Full IFRS
- > overall disclosures requirements for SMEs are decreased about tenfold compared to entities applying Full IFRS
- > simplified redrafting.

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RSM International has released a new publication titled *A Guide Through IFRS for Small and Medium-sized Entities (SMEs)* that can be downloaded from www.rsmi.com.



Stefano Bianchi

Exposure draft proposes new classification and measurement guidance for financial instruments

Milestones

Objectives:

- > To simplify financial instruments' accounting. The IASB has received expressions of concern regarding the difficulty to understand, apply and interpret many requirements of IAS 39 from many users of financial statements and other interested parties. The Board has been under great pressure to develop a new standard of financial reporting for financial instruments that is more principle-based and less complex. Although the Board has amended IAS 39 several times to clarify requirements, add guidance and eliminate internal inconsistencies, it has not previously undertaken a fundamental reconsideration of reporting for financial instruments.
- > The ED is one of the responses of the IASB to the global financial crisis and is consistent with the recommendations made by the G20 and the Financial Stability Forum.

Current status:

- > Exposure Draft published on 14 July 2009
- > Comment letters closed on 14 September 2009

What's next:

- > The IASB expects to finalise the new classification and measurement model in time to allow entities to voluntarily adopt the new model for 31 December 2009 year-end financial statements. The finalisation of the remaining parts of the new standard is expected in 2010.

On 14th July 2009, the IASB issued the exposure draft (ED), ED/2009/7, Financial Instruments: Classification and Measurement. The ED is part of the IASB's project to replace IAS 39, *Financial Instruments: Recognition and Measurement*. The ED proposes a new classification and measurement model for financial assets and financial liabilities.

This exposure draft is the first of four EDs that will replace IAS 39 or amend it. The others are:

- > ED on derecognition (issued in March 2009)
- > ED on impairment methodology (expected in October 2009)
- > ED on hedge accounting (expected in December 2009)

The ED proposes to reduce the financial instrument classification and measurement categories and their associated impairment models in IAS 39 from many to two, i.e. 'amortised cost' and 'fair value'.

The main points are:

- > new criteria for amortised cost measurement
- > new measurement category - fair value through other comprehensive income (OCI)
- > for debt instruments, only those financial assets and liabilities that have basic loan features and are managed on a contractual-yield basis are eligible for amortised cost
- > all equity investments to be measured at fair value through profit or loss unless at initial recognition the entity elected to present changes in fair value through OCI and they are not held for trading
- > impairment assessment only for amortised cost assets
- > no more available-for-sale assets and held-to-maturity assets and tainting rules
- > no more reclassifications between categories
- > removal of the requirement to assess a financial instrument for embedded derivatives.

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Denise Gomez Soto

Project on Financial Statement Presentation

Amid the current financial turmoil there is one thing that has remained constant: the importance of solid communication. In 2004, the IASB and the US Financial Accounting Standards Board (FASB) initiated a joint project on financial statement presentation. The aim of the project was to improve the presentation of financial statements so that they provide better communication between preparers and users (analysts and investors). Preparers would be able to better communicate the unique aspects of their businesses, and users would be able to understand this message more accurately.

In October 2008, the IASB and the FASB published a joint document for discussion: Preliminary Views on Financial Statement Presentation. This discussion paper invited comments on the boards' preliminary views on a proposed model for presenting information in the financial statements. The comment period ended on 14 April 2009.

Why a project on presentation?

The model would address users' concerns that existing requirements permit too many alternative types of presentation, and that information in financial statements is highly aggregated and inconsistently presented. These problems make it difficult to fully understand the relationship between the financial statements and the financial results of an entity. The proposed joint model is designed to make entities' financial statements more useful, by requiring entities to provide disaggregated (detailed) information organised in a manner that clearly communicates an integrated (cohesive) financial picture of an entity.

Phases of the project

The financial statement presentation project is structured in three phases. Phase A provided a general overview of the presentation of financial statements and ended with the release of a revised IAS 1 in 2007. Phase B (the current phase) deals with fundamental issues regarding presentation. Phase C will deal with requirements for interim reporting.

The presentation project is intended to apply to all business entities and to all financial statements. It is not changing the measurement-recognition or underlying accounting of items in the financial statements or creating new measures per share. Current note disclosures will remain except when they become redundant because of new presentation requirements.

Objectives (renamed as "core principles" at the July 2009 meeting)

The Boards developed three objectives for financial statement presentation based on the objectives of financial reporting and on the input that the Boards received from users of financial statements and from members of their advisory groups. These three objectives are:

- > Information shown in the financial statements should portray a cohesive picture of an entity. Assets, liabilities and equity would be classified consistently in the financial statements, according to predefined sections, categories and subcategories, so that users could understand the relationships between items across different financial statements
- > Information should be disaggregated to improve the prediction of future cash flows. Financial statement analysis requires financial information that is reasonably disaggregated, and which ensures that items that respond differently to economic events are shown separately
- > Information should also help in assessing an entity's liquidity and financial flexibility. Liquidity means that an entity has enough resources to meet its financial commitments. Financial flexibility means that an entity has enough to fund future growth and to respond to unexpected needs and opportunities. [At the July 2009 meeting the Boards decided to consider this objective in the context of the disaggregation principle.]

Structure

The proposed presentation model requires an entity to present information about the way it creates value (its business activities) separately from information about the way it funds those business activities (its financing activities). An entity should also present separately information about its discontinued operations and about its income taxes. In its statement of comprehensive income, an entity should allocate its income tax expense (benefit) to income from continuing operations; discontinued operations; and other comprehensive income items.

To prepare financial statements using the classification scheme, an entity should first classify its assets and liabilities into the sections and categories in the statement of financial position. That classification should then be replicated in the statements of comprehensive income and cash flows.

An entity should present subtotals and related headings for each section and category. It may present additional ones if such presentation would be helpful in understanding its financial position and changes.

Management will decide how to classify its assets and liabilities in a manner that best reflects how management views and manages the entity and its resources (this is called a “management approach”). This classification should be based on the predefined sections and categories. Classifications in the financial statements should be clearly described as part of an entity’s accounting policies note disclosure and any change should be implemented through retrospective application.

How the financial statements might change

Statement of financial position

The statement of financial position would be grouped by major activities (operating, investing and financing), instead of by assets, liabilities and equity as it is today. Assets and liabilities would be disaggregated into short-term and long-term subcategories within each category. The only exception would be if an entity believes that presenting assets and liabilities in order of liquidity provides more relevant information. Totals for assets and liabilities, and subtotals for short-term and long-term assets and liabilities, would be presented in the statement of financial position or in the notes to financial statements.

Statement of comprehensive income

The proposed presentation model eliminates the choice that an entity currently has of presenting components of income and expense in an income statement and a statement of comprehensive income (the two-statement approach). All entities would present a single statement of comprehensive income, with items of other comprehensive income presented in a separate section. This statement would include a subtotal of profit or loss or net income and a total for comprehensive income for the period.

In addition to classifying its income and expense items into the operating, investing and financing categories, an entity should disaggregate those items on the basis of their function within those categories. The entity should further disaggregate its income and expense items by their nature when this disaggregation helps users in predicting an entity’s future cash flows.

Statement of cash flows

To determine its cash flows, an entity should use a direct method, rather than reconciling profit or loss or net income to net operating cash flows (an indirect method). The Boards observed that a direct method is more consistent than an indirect method with the proposed objectives of financial statement presentation.

New reconciliation schedule

The proposed presentation model includes a new schedule (to be included in the notes to financial statements) that reconciles cash flows to comprehensive income. This reconciliation schedule disaggregates income into its cash, accrual other than remeasurements, and remeasurement components (for example, fair value changes). Users analyse those components separately because the components often differ in their ability to help users to predict future cash flows and assess earnings quality.

Evolution or revolution?

The IASB and the FASB boards believe that the proposed model will enhance presentation of the financial statements. The Boards hope to learn more about the costs and benefits of their proposed presentation model through the comments they have received on this discussion paper, and from the results of a field test, as well as from discussions that were held with interested parties during the comment period. The Boards are now redeliberating the issues addressed in their discussion paper to develop an exposure draft of a proposed standard (planned to be issued in mid-2010).

For more information about the project, go to: <http://go.iasb.org/FSP-DP>

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Marycken van Dijke

The effect of minimum funding requirements on defined benefit pension plans of IFRIC 14

Introduction

The challenges of preparing financial statements in accordance with IFRS have increased due to the changes in the financial markets (see extract 1). The impact on the defined benefit pensions due to changes in the fair value of the plan assets is significant. This effect may be enhanced by funding arrangements between reporting entities and their pension fund. Furthermore, especially in countries that have a history of granting employees defined benefit schedules, every so often local rule setters issue national capital standards, which provide for the case of pension funds having funding shortfalls. In this article we will report on the impact of minimum funding requirements on the treatment of pension assets in the balance sheet and the impact on (additional) obligations in the balance sheet.

IFRIC 14, endorsed by the EU in 2008, addresses the following issues:

- > how entities should determine the limit placed by IAS 19 Employee Benefits on the amount of a surplus in a pension plan they can recognise as an asset
- > how a minimum funding requirement affects that limit and
- > when a minimum funding requirement creates an onerous obligation that should be recognised as a liability in addition to that otherwise recognised under IAS 19

General

Due to the impact of changes in the financial markets on the fair value of plan assets, entities reporting under IAS 19, *Employee Benefits* with defined benefit schedules generally will recognise a pension liability in their balance sheet.

A pension asset may be limited in the balance sheet as an asset ceiling test must be applied to determine that the asset does not exceed:

- > the part of the pension surplus, measured as the present value of the economic benefits available to the entity in the form of refunds from the plan and/or reductions in future contributions to the plan, plus
- > the unrecognised actuarial losses and unrecognised past service cost

IFRIC 14 provides new guidelines on the recognition of pension assets and the effect of minimum funding requirements on entities with a defined benefit pension plan. IFRIC 14 states that the economic benefits are considered available even when realised in the future. Generally this is considered to be a wider interpretation than applied under IAS 19 when the economic benefits were only considered available at the balance sheet date. This interpretation results in an increased ability to recognise a pension surplus in the balance sheet. (See Extract 2)

It is interesting to conclude, based on IFRIC 14, that if there is a minimum funding requirement in connection with a funding shortfall, additional obligations may have to be considered even if the entity already reports a pension liability. (See Table 1)

Table 1: Defined Benefit reported in balance sheet in line with IAS 19

Example	31.12.2009	31.12.2008
Present value of defined benefit	(9,200)	(9,000)
Fair value of plan assets	9,100	9,500
Pension (deficit)/surplus	(100)	500
Unrecognized actuarial losses/(gains)	20	20
Pension (liability)/assets	(80)	520

Minimum funding requirements

Asset ceiling test

Minimum funding requirements

Minimum funding requirements exist in many countries to improve the security of the post-employment benefit promise made to members of an employee benefit plan. Such requirements normally stipulate a minimum amount or level of contributions that must be made to a plan over a given period. Funding requirements that arise from local legislation are generally included in capital standards for pension funds that set requirements for pension funds' funding ratios.

A minimum funding requirement may arise from local legislation and regulations but also directly from an agreement between the entity and the pension fund. Funding arrangements between the entity and the pension fund are generally incorporated in a funding policy agreement. The contributions stipulated in the agreement are regarded as minimum funding contributions.

If a pension fund does not meet the funding ratios and consequently has a pension shortfall, the trustees will prepare a recovery plan including the term by which the fund will be able to meet the capital standards. As part of the recovery plan, a pension fund may agree additional contributions with the entity in the form of a single payment or future contributions.

Normally, a requirement to make contributions to a plan would not affect the measurement of the defined benefit asset or liability. This is because the contributions, once paid, will become plan assets, hence the additional net liability is nil. However, a minimum funding requirement may give rise to a liability if the required contributions will not be available to the entity once they have been paid.

Consequently, even when the entity reports a pension liability the application of IFRIC 14 may lead to additional obligations, in cases where minimum funding requirements exist.

Effect on the obligations in the balance sheet

To demonstrate the effect of a pension shortfall within the pension fund on the obligations in the balance sheet when minimum funding requirements exist, the example below is illustrative (CU=currency unit):

- > the entity reports a pension deficit of CU100
- > the pension fund has a pension shortfall: the actual funding ratio is 95%, whilst the required funding ratio is 105%
- > given the requirements the pension fund and the entity agree on an additional contribution to be paid by the entity of CU200
- > due to this contribution, the pension deficit at the entity is eliminated and would change into a pension surplus of CU100

To test if this surplus is available for the entity (the asset ceiling test), IFRIC 14 first assesses if the full amount of the pension surplus is covered by the amount of the unconditional right to a refund. IFRIC 14 lists a number of ways an unconditional right may arise, including:

- > the administration agreement between the entity and the pension fund states that 70% of the surplus is available for the entity on settlement of the plan. For instance on single settlement, if the fund is being transferred to another insurer the amount available of the total pension surplus on settlement of the plan is CU70
- > consequently, an additional pension obligation in the financial statements exists of 30% of CU100 resulting in an increase of the total pension liability from CU80 to CU110 (=80 + 30)

IFRIC 14 considers how much of a pension surplus is available to the entity. Firstly, as shown in the above example, by determining the amount of the surplus available through an unconditional right to a refund and, secondly, by determining the amount available to the entity in the form of future contribution reductions. An unconditional right is not required for future contribution reductions but if only a part of the pension surplus is available through a refund, the entity has to perform complex calculations to determine if the (remaining) pension surplus can be recognised on the balance sheet based on the availability of future contribution reductions. In practise it may be helpful to improve pension agreements and their disclosures to provide evidence that there is an unconditional right to a refund.

Extract 1

Pensions

If the financial markets deteriorate further, our pension deficit may increase, impacting balance sheet liabilities, which may in turn affect our ability to raise additional funds.

(British Airways, 2008/09 Annual Report and Accounts, p. 33)

Noteworthy: in addition to the liabilities impacting the ability to raise funds the pension deficit is also a concern the merger discussions with Iberia, for which you should refer to Q4 2008 transcript.

Extract 2

IFRIC 14 “Limit on a Defined Benefit Asset, Minimum Funding Requirements and Their Interaction” is effective for periods beginning on or after January 1, 2008, and provides guidance on assessing the limit in IAS 19 “Employee Benefits”, on the amount of the surplus that can be recognised as an asset. It also provides guidance on how the pension asset or liability may be affected by a statutory or contractual minimum-funding requirement. The results for the year ended March 31, 2008, have been restated accordingly. The net impact on the income statement for the year ended March 31, 2008, is a £36 million increase in finance income. The net impact on the balance sheet as at March 31, 2008, is a £235 million increase to shareholders’ equity and a £235 million increase in employee benefit assets.

(British Airways, 2008/09 Annual Report and Accounts, p. 87)

It is noteworthy that the £235 million increase is not really explained. From elsewhere in the report, though, it is possible to notice that BA has put the best part of £1.5b into the two main pension schemes over the last three years, which incidentally is more than the company’s profits over that period. It is ultimately a question of negotiation between the trustees and the company as to what the level of ongoing contributions should be. However, given the history, it does not seem likely that there will be an increase in the level of contribution from the £320m that they are contributing today.

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Chandra Sekaran

Accounting for Borrowing Costs under International Accounting Standard 23

1. Accounting treatment under IAS 23

As part of the short-term convergence project conducted jointly with the FASB, the IASB issued the revised IAS 23 in March 2007. The revised standard makes it mandatory to capitalise borrowing costs that are directly attributable to the acquisition, construction or production of a qualifying asset. The Board decided to eliminate the option of immediate recognition of such borrowing costs as an expense since it believes this will result in an improvement in financial reporting as well as achieving convergence with US GAAP. The revised standard refers to borrowing costs relating to qualifying assets for which the commencement date for capitalisation is on or after 1 January 2009.

2. Practical issues relating to borrowing costs

Definition of Borrowing Costs

i) One of the definitions of borrowing costs includes exchange differences arising from foreign currency borrowings to the extent that they are regarded as an adjustment to interest costs. In our view the gains and losses that are an adjustment to interest costs include the interest rate differential between the borrowing costs that would be incurred if the entity borrowed funds in its functional currency and borrowing costs actually incurred on foreign currency borrowings because exchange rate movements are closely correlated with differential interest rates. Other movements in exchange rates due to general economic indicators such as employment or productivity should not be considered as borrowing costs eligible for capitalisation. For example, if a company domiciled in UK has US\$2 million borrowings at an interest rate of 4% and an equivalent borrowing in sterling would carry an interest rate of 6%, the borrowing costs to be capitalised would include the actual interest paid in US\$ translated at the foreign exchange rates into sterling, plus the difference between the interest on sterling equivalent of borrowings and the actual interest incurred. Other movements in exchange fluctuations in this case would be accounted as per IAS 21 as foreign exchange gain or loss in the income statement.

ii) IAS 39 and IAS 23 do not provide guidance on whether an entity can cash flow or fair value hedge interest rate risk when the interest is partly or fully capitalised under IAS 23 as part of a qualifying asset. IAS 23 makes reference in its basis of conclusions that US GAAP does provide specific guidance in this area for when there are fair value hedges for interest rate risk for borrowings which are used to finance purchase of a qualifying asset. As per Basis of Conclusions paragraph 21 of IAS 23, EITF (U.S. Emerging Issues Task Force) Issue No. 99-9 concludes that derivative gains and losses arising from the effective portion of a derivative instrument that qualifies as a fair value hedge are part of the capitalised interest cost. IAS 23 does not address

such derivative gains and losses. In our view, changes in fair value of interest rate swaps should not be considered as borrowing costs. It is preferable to consider only those accruals under interest rate swaps entered into as a hedge of eligible borrowing costs. Further US GAAP prohibits the capitalisation of gain or loss on the hedging instrument in a cash flow hedge. IAS 23 does not address instances where there are derivative financial instruments such as interest rate swaps that are commonly used to manage interest rate risk on borrowings that are used to finance for qualifying assets. When an entity borrows at fixed rates and enters into an interest rate swap (with the same notional amount and term as the debt) to receive fixed pay and designates this as a hedge of the fair value exposure to changes in interest rates of its debt, in our view, the entity would capitalise borrowing costs which would include actual fixed rate on the debt plus the effect of swapping this fixed rate into floating rates. When an entity borrows at floating rates and enters into an interest rate swap to receive three months LIBOR fixed rates (same notional and term as debt) and designates the swap as hedging the variability in its debt due to changes in three months LIBOR, this is a cash flow hedge, in this case, the entity would capitalise variable interest rate on borrowings as per IAS 23. As per IAS 39, the effectiveness portion of the hedge would be recognised in other comprehensive income and the ineffectiveness portion in the income statement. The amount recognised in other comprehensive income would be reclassified to the income statement, when the hedged risk impacts the income statement. In this case, the impact would be in the income statement when the qualifying asset is depreciated or amortized, impaired or sold. When the hedge accounting is not applied by the entity, derivative gains or losses are accounted in the income statement as per IAS 39 and hence, the entity would not capitalise part of the derivative gain or loss under borrowing costs as per IAS 23.

iii) IAS 23 does not address other instances where an entity may finance its operations such as gains and losses on derecognition of borrowings, dividends payable on shares classified as financial liabilities that have been recognised as an expense in profit or loss, and the unwinding of discounts that may be included within the caption 'finance costs' in the income statement. In our view, gains and losses on derecognition of borrowings are not eligible for capitalisation since the decision to make an early settlement of borrowings is not attributable to a qualifying asset. Similarly unwinding discounts relating to onerous leases and decommissioning costs will not qualify under IAS 23 since they are not attributable to a qualifying asset. In the case of dividends payable on redeemable preference shares classified as financial liabilities, this would meet the definition of borrowing costs under IAS 23 whereas this would not be case when there are irredeemable shares.

General Borrowings

In the case of general borrowings, IAS 23 requires a capitalisation rate to be applied on expenditure on the relevant assets. Here the standard does not define the expenditure on the asset. An appropriate method could be to calculate the weighted average carrying amounts of the assets during the period (including borrowing costs previously capitalised on these assets) and then apply the capitalisation rate.

Qualifying asset

A qualifying asset is one that necessarily takes a substantial period of time to be made ready for its intended use or sale. IAS 23 does not define substantial period of time. Management has to exercise its judgment when determining which assets are qualifying assets, taking into account the nature of the asset. In our view, an asset that normally takes more than a year to be ready for use will usually be a qualifying asset. Management discloses in the notes to the financial statements, when relevant, how the assessment was performed, which criteria were considered and which types of assets are subject to capitalisation of borrowing costs. Further, there is no guidance in the standard regarding whether an asset that is refurbished can be a qualifying asset. In our view, interest can be capitalised when the refurbishment costs qualify for capitalisation and whether that will take a substantial period of time and other criteria are met. In the case of qualifying assets held by joint venture, it is not appropriate to capitalise interest on the borrowings of the partners but if the venturer is using proportionate consolidation and the jointly controlled entity itself does not incur borrowing costs, then the venturer should capitalise borrowing costs that relate to its share of the qualifying asset in its consolidated accounts.

Tax on capitalised borrowing costs

IAS 23 does not specify whether borrowing costs should be capitalised gross or net of tax. In our view, they could be capitalised net of tax taking into consideration that the tax relief is treated in the same way. If the gross method is applied, a deferred tax liability is accounted for as per IAS 12, *Income Taxes*. Appropriate disclosures should be made in the financial statements and the method used either gross or net should be consistently applied.

Accounting treatment for borrowing costs in consolidated and separate financial statements

There is no specific guidance in IFRS relating to the calculation in consolidated financial statements apart from the fact that it is mentioned that the amount of borrowing costs to capitalise should be based on a weighted average borrowing rate applicable for the group rather than a weighted average rate applicable to an individual entity's borrowings. In our view, where financing is done at each subsidiary level, entity specific rate for that subsidiary should be taken whereas if all borrowings are centralized, a group borrowing rate is more preferable. Only external

borrowings should be taken into consideration for the purpose of determining the weighted average group borrowing rate. If a parent entity borrows funds and a subsidiary uses these funds for incurring expenditure on qualifying assets which are recognised in the books of the subsidiary, then our view is that borrowing costs cannot be capitalised in the separate financial statements of the parent and subsidiary, but rather only in the consolidated financial statements.

Differences between IAS 23 and SFAS 34

In substance, IAS 23 fully converges with SFAS 34. However, there still are some differences such as:

- i) SFAS includes as qualifying assets investments in investees accounted for using the equity method in certain cases whereas these are not qualifying assets as per IAS 23
- ii) SFAS does not permit capitalisation of interest costs on assets acquired with gifts or grants that are restricted by the donor or grantor in some situations whereas IAS 23 does not address such assets

In addition, purely semantic differences, too, persist, e.g. IAS 23 uses the term borrowing costs whereas SFAS 34 uses the term interest costs.

Finally, IAS 23 defines qualifying asset as that which would take a substantial period of time to get ready for its intended use whereas SFAS definition does not include the term substantial.

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David Talbot Discussion paper on leases

Leasing is a widely used source of finance for many businesses and it is therefore important that users of financial statements have a clear understanding of what leasing arrangements entities have entered into. This is why the IASB has undertaken a joint project with the FASB aimed at addressing problems with existing lease accounting treatment and developing a new common approach to lease accounting. The discussion paper on lease accounting, issued in March 2009 (with deadline for comments on 17th July 2009), presents the IASB's and FASB's preliminary views on this topic.

The current accounting model

The current approach to lease accounting requires lessees to classify each contract as either an operating or finance lease. The principle is that leases which substantially transfer to the lessee the risks and rewards of ownership are finance leases, otherwise they are operating leases. The finance lease accounting model results in the recognition of an asset and associated liability, whereas the operating lease accounting model only recognises as an expense the annual charge and discloses future commitments to lease rental payments.

The discussion paper acknowledges a number of criticisms of this approach, being that:

1. many users believe that an operating lease gives rise to an asset and liability, and that users would make adjustments to the financial statements to reflect the effect of such leases
2. similar transactions can be accounted for in very different ways under the operating and finance lease accounting models respectively
3. the current approach provides an opportunity to structure transactions to achieve a desired lease categorisation
4. it can be difficult to apply in practice, i.e. to define the dividing line between classification can be challenging for preparers

Scope

The Boards decided that the existing leasing standard's scope was more appropriate than a fundamental reconsideration of what constitutes a lease. This view was adopted as it was felt existing guidance about what a lease is was clear, and that it would be more familiar to preparers.

A simple lease

The discussion paper considers a simple lease first of all, and concludes that it has the following attributes:

Right	Obligation
Right to use the asset for lease term	Obligation to pay rentals
	Obligation to return the asset

The right to use the asset and the obligation to pay rentals are considered an asset and liability respectively as they meet the definition of the IASB's Framework for Preparation and Presentation of Financial Statements. The obligation to return the asset is not a liability, as at the end of the lease term the entity has no right to future economic benefits from the asset.

The result of this approach is that all leases result in the recognition of an asset and liability, thus removing the differing treatment of operating and finance leases under the existing approach.

In order to consider measurement, it is first necessary to consider the other components that arise in complex leases, which include:

- > options to extend, terminate and purchase
- > variable or contingent rental payments
- > compensation to lessor for decline in residual value

It was concluded that such components would not be considered separately (with the exception of embedded derivatives that may need to be separately recognised under IAS 39), as they are often interrelated and therefore it may be difficult to establish a fair value for them. The discussion paper therefore proposes that a single asset and liability is recognised including all rights and obligations respectively.

Initial measurement

Initial measurement of the liability and asset under the proposed approach is similar to the current approach to finance leases, i.e. the liability is estimated based on present value of future minimum rental payments and the initial cost of the asset is equal to this value. However, the key difference in this new approach to measurement is that the lessee's incremental borrowing rate is used to discount the rental payments, rather than the rate implicit in the lease.

This is a sensible approach as the rate implicit in the lease is often more difficult to determine than an incremental borrowing rate of an entity as it requires the determination of the lessor's estimate of residual value, something which the lessee may be unable to obtain.

In addition it is more relevant to users in assessing the entities financial position as the financing element of the lease is more closely comparable to other sources of finance, such as debt, which may have been an alternative method of financing an asset purchase.

On initial measurement of complex leases, such as those including options, it is proposed that the most likely outcome approach is used. This involves assigning probabilities to options and including the most likely outcome in the initial measurement. For example, with an option to purchase, the entity will consider whether it will purchase the asset or not at the outset of the lease, and include or exclude as appropriate the option payment in the minimum lease payments calculation. This approach fairly reflects the binary nature of such options.

This principle also applies where there may be multiple options, such as both an option to extend or to purchase. The view of the Boards is that the most likely option is used in the initial measurement calculation.

Whilst this approach will reflect the most likely outcome of the lease, it still involves management judgement. Hence, a preparer could still manipulate the accounting treatment as, for example, the judgement taken in respect of an option will impact on the quantum of both the asset and liability. Therefore this may lead to difficulties in practice for preparers who will have to provide sufficient evidence to justify decisions to auditors.

In addition, there is the potential that two entities could treat the same lease differently depending on their views on an option. The potential effect of this is illustrated in *Exhibit 1*. This reduces the potential comparability of different entities' financial statements dependent of management's view on initial recognition, even though the outcome may ultimately be the same. It is therefore important that guidance is given to provide a reference point for preparers on the type of indicators which would justify decisions for accounting treatment. For example, if a lease contained an option to purchase at below market value at the end of the lease, should an entity be allowed to choose not to include the option in the minimum lease payments? There may be circumstances which may result in the exercise of the option being unlikely, such as the lack of available finance, but the majority of commercial organisations would surely exercise such an option.

Subsequent measurement

Subsequent measurement of the liability is on an amortised cost basis, using the entity's incremental borrowing rate. The IASB's view is that the incremental borrowing rate is reassessed throughout the lease, although it is not yet clear when this should occur. The FASB's view is that this should not be reassessed.

Both Boards agree that accounting for a change in the obligation to pay rentals results in a change in the liability, and that in all circumstances but the treatment of contingent rentals, that they should be reflected in the carrying value of the asset. The discussion paper proposes that the most likely lease term is assessed at each reporting date, and re-measured as appropriate.

For example, a five year lease has an option to extend the lease term for two years, and was initially measured for the minimum lease term on the expectation that the option would not be exercised. At the end of year three, the option is now considered likely to be exercised, so it is necessary to re-measure the minimum lease payments over the revised term. As discussed above, the IASB proposed these payments be discounted using the entities current incremental borrowing rate, whilst the FASB approach would be to use the original rate.

With the exception of changes to lease terms above, the link between the asset and liability on initial measurement is not maintained for subsequent measurement of the asset. The 'right of use' asset is treated like other assets of its class, it is depreciated or amortised, and is subject to impairment review. Neither the depreciation nor any potential impairment result in a change in the obligation to pay rentals, therefore there is no need to re-measure the liability. The Boards considered the use of fair values but it was considered that the cost of such an approach outweighed the benefits. A summary of the considerations is shown in the table below.

Measurement method	Fair value	Amortised cost
More relevant to the user?	Yes	No
Consistent with treatment of other non-financial assets?	No	Yes
Difficult and costly?	Yes	No

Concerns with the proposals

There are two main concerns with this discussion paper, the first is that lessor accounting has not yet been fully considered. If a standard were to be issued without full consideration of lessor accounting, it could lead to issues of inconsistency between lessee and lessor accounting. The IASB and FASB are however looking into lessor accounting now.

Secondly, there are inconsistencies between the views of the IASB and the FASB therefore there would be differences between IFRS and US GAAP on a newly developed standard, which does not bode well for further convergence. These differences, in addition to the differing views of the reassessment of entities' incremental borrowing rate discussed above, include contrasting views on the treatment of contingent rentals, such as turnover rent. The IASB proposes that these are initially measured on a probability weighted basis, whereas the FASB's view is to take the most likely outcome basis. A further difference arises on the reassessment of such contingent rentals, FASB's view is to take changes to profit or loss, and IASB's view is to adjust the right-of-use asset. Clearly, a consistent view on all aspects of accounting within IFRS is important if IFRS is to become a truly global applied set of standards.

Exhibit 1

An example lease illustrating the effect of option decisions on initial recognition

Minimum lease term	5 Years
Optional lease period	3 Years
Initial period rental charge	€ 500 per annum
Subsequent period rental	€ 400 per annum
Incremental borrowing rate	8%

Fair value on initial recognition

Option not expected to be exercised	€ 1,996
Option expected to be exercised	€ 2,698

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Stefano Bianchi... selects challenging examples from practice

The derecognition of financial assets is one of the most difficult areas of IAS 39, which is widely considered as the most challenging IFRS of all.

The term “Derecognition” can sound bizarre to most of the non-technical readers, however in the last few years the less technical readers have become accustomed to finding in the non-financial pages of many newspapers terms such as SPV (Special Purpose Vehicle), SPE (Special Purpose Entity), SIV (Special Investment Vehicle), securitisation and factoring. Securitisation structure, for example, has been pointed out as one of the main culprits of the global financial crisis (*see Extract 1*), and new derecognition rules have been invoked as a possible solution to prevent certain distortions from occurring again in the financial statements.

As the implementation of derecognition criteria has encountered a significant increase of complexity and challenges, this topic has been included in the Top Ten Topics section in RSM Reporting which focuses on the challenges met in IFRS implementation around the world. Hence, in this edition we address:

“Derecognition of financial instruments and Consolidation of Special Purpose Entities”

The starting point for all the analyses and tests of derecognition criteria is the decision tree proposed in IAS39 AG36 (*see Figure 1*) and the recommendation is to seek technical advice in cases where the criteria are met.

1. Consolidation of all SPV

The first step of the decision tree is to identify the reporting entity that needs to assess the derecognition criteria; if the reporting entity is the group, all the subsidiaries, including SPVs, should be analysed in order to assess whether consolidation is required. SPVs, SIVs and SPEs are often structured as ‘auto-pilot mechanisms’ (*see Frame 1*) in order to support the securitisation structure. However, even if the legal ownership of these vehicles is with third parties, e.g. a Trust, the substantial control of such entities is often still with the originator (i.e. the company that sold the financial assets), in which case the vehicle should be consolidated in the originator’s consolidated financial statements. (*See Extract 2*)

A typical securitisation scheme is illustrated in the chart in Figure 2.

It has emerged in the practice that the main challenge, at this stage, is posed by the ambiguity of where the control lies and, hence, with the identification of the entity that should assess the criteria.

2. Risk and rewards test

An entity should derecognise an asset if it transfers substantially all the risks and rewards of ownership of the asset. Examples of when an entity has transferred substantially all the risks and rewards of ownership are:

- > an unconditional sale of a financial asset
- > a sale of a financial asset together with an option to repurchase the financial asset at its fair value at the time of repurchase
- > a sale of a financial asset together with a put or call option that is deeply out of the money (an option so far out of the money it is highly unlikely to go into the money before its expiry date)

The challenge of this stage lies in quantifying and therefore testing the transfer of risks and rewards. This has often been evaluated as the entity’s exposure, before and after the transfer, to the variability in amount and timing of the cash flows that are likely to occur.

Currently it is widespread practice to fix the threshold of transfer of risks and rewards at 90%, however this does not solve the main issue of the quantification of the transfer. (*See Extract 3*)

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

3 Top Ten Topics in IFRS

3. Continuing involvement

If the full derecognition has not been achieved, the preparer needs to use the continuing involvement approach and will recognise part of the asset transferred. The amount of the asset that continues to be recognised is the maximum amount of the entity's exposure to that particular asset or its previous carrying amount, if lower.

The challenge to the preparer is to estimate the value of the continuing involvement. (See Extract 4)

4. What's next

Such is the complexity of the current requirements and the resulting difficulty in applying them in practice, that the IASB issued an Exposure Draft on derecognition in March 2009. The new model is focused on control instead of transfer of risk and rewards. The new standard is expected to be issued in 2010 so... watch this space!

Figure 1: Decision tree (IAS 39 AG36)

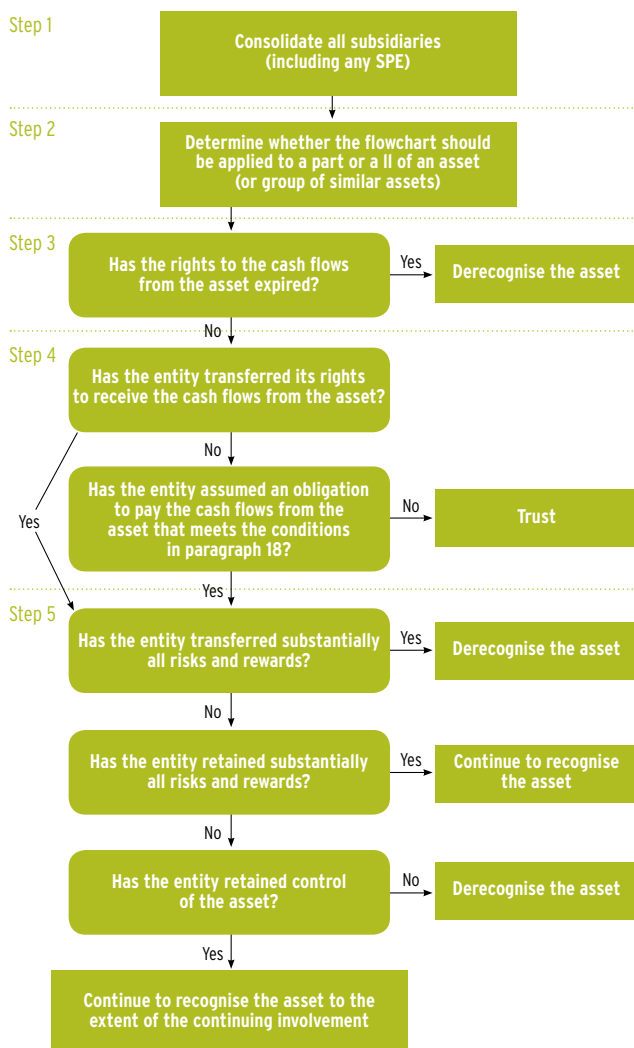
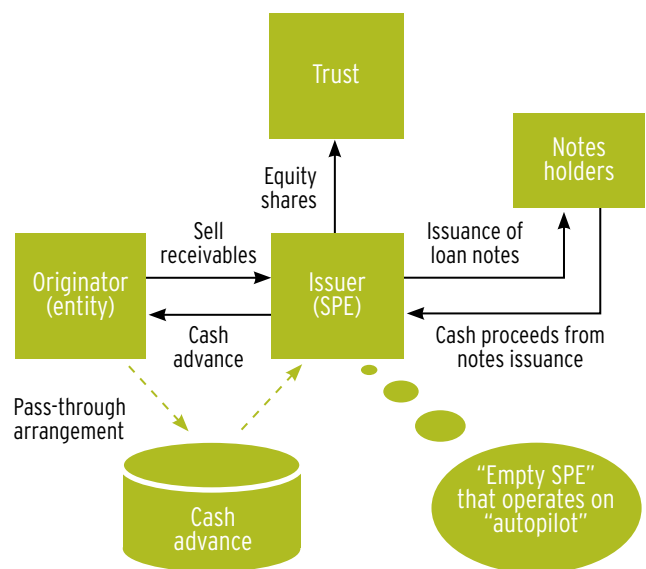


Figure 2: Illustration of a typical securitisation scheme



Frame 1

IASB Board Meeting 18-20 October 2005, London

On the issue of autopilot mechanisms, the Board made the following points:

- > If management decisions have to be made on an ongoing basis, it is not an autopilot mechanism (otherwise any entity could be put onto an 'autopilot' mechanism)
- > In a pure autopilot mechanism, the power criteria can in most cases be assessed as immaterial in assessing whether an entity is a subsidiary of another entity (versus the notion that power has already been exercised by setting up the autopilot mechanism)
- > In the context of an example presented to the Board (paragraph 37 of the Observer Notes), it was noted that generally, certain autopilot mechanisms will represent interests in undivided assets, consequently the Board may require legal assistance in order to explore that further, noting that global applicability of that legal guidance will be problematic. However, Board members indicated that the example did not have the full facts and did not explore whether the arrangement is in fact a joint venture

Extract 1

"...when structured investment vehicles were sowing devastation in the financial world, I frantically searched for a way to explain to non-financiers how these entities worked. The analogy I resorted to was a garage or cellar. For just as a garage or cellar is usually attached to a house-but not truly inside a house- entities such as SIVs and conduits have traditionally had a semi-detached status with banks"

(Financial Times, Gillian Tett, 18 September 2009, "Why we should all watch what Barclays does in the cellar")

Extract 2

"In a number of cases, these SPEs are accounted for off-balance sheet under IFRSs where HSBC does not have the majority of the risks and rewards of ownership of the SPE. However in certain circumstances, after careful consideration of the facts, HSBC consolidates an SPE when, although it does not obtain the majority of risks and rewards of ownership, the qualitative features of HSBC's involvement indicate that, in substance, the activities of the SPE are being conducted on behalf of HSBC. HSBC reassesses the required consolidation accounting tests whenever there is a change in the substance of the relationship between HSBC and an SPE, for example, when the nature of HSBC's involvement or the governing rules, contractual arrangements or capital structure of the SPE change."

(HSBC, 2008 consolidated financial statements, p. 173)

Extract 3

[In respect of the transfer of risks of receivable sold through securitisations] "The Sales financing division undertook several securitisation operations through special purpose vehicles (in France, Italy and Germany) involving receivables on the dealership network or loans to final customers. This did not lead to derecognition of the receivables assigned, as all risks were retained by the Group. Sales financing receivables in the balance sheet thus amounted to €7,026 million at December 31, 2008 (€6,776 million at December 31, 2007 and €5,727 million at December 31, 2006). A liability of €3,493 million was recognised at December 31, 2008 (€3,533 million at December 31, 2007 and €3,108 million at December 31, 2006) in other debts represented by a certificate, corresponding to issues resulting from the securitisation operations."

(Renault 2008 consolidated financial statements, p.41)

Extract 4

As an example HSBC discloses that: "The rights and obligations that HSBC retains from its continuing involvement in securitisations are initially recorded as an allocation of the fair value of the financial asset between the part that is derecognised and the part that continues to be recognised on the date of transfer. The following analyses the carrying amount of financial assets to the extent of HSBC's continuing involvement that qualified for partial derecognition during the year, and their associated liabilities:

	Securitisations at 31 December	
	2008 US\$m	2007 US\$m
Carrying amount of assets (original)	17,427	17,713
Carrying amount of assets (currently recognised)	299	598
Carrying amount of associated liabilities (currently recognised)	149	299

(2008 HSBC Holdings plc Annual Report and Accounts, p. 406)

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