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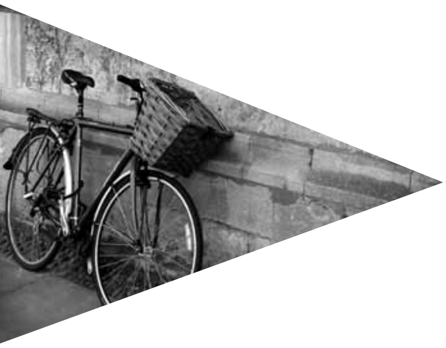
IFRS Outlook



In this issue ...

Regulators' concerns over impairment disclosures: how entities can improve their compliance with IAS 36

European regulators are concerned about the adequacy of impairment disclosures made by IFRS reporters under IAS 36 *Impairment of Assets*. We discuss the main findings of a report issued earlier this year by the European Securities and Markets Authority.

IASB moving towards an improved IFRS framework

As a result of the feedback received on the Agenda Consultation in 2011, the IASB restarted the *Conceptual Framework* project in September 2012. We speak to Stephen Cooper, member of the IASB, to get his thoughts on the importance of the project and the challenges faced.

IFRS project update

Find out which projects the IASB and the IFRS Interpretations Committee are currently discussing.

Resources

Look here for an up-to-date list of our recent publications.

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Ruth Picker
Global Leader of IFRS Services

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Regulators' concerns over impairment disclosures: how entities can improve their compliance with IAS 36

European regulators are concerned about the adequacy of impairment disclosures made by IFRS reporters under IAS 36 *Impairment of Assets*. Here, we discuss the main findings of a report issued earlier this year by the European Securities and Markets Authority (ESMA).

In January 2013, the ESMA published a report, *European enforcers' review of impairment of goodwill and other intangible assets in the IFRS financial statements*, which expressed concerns about the adequacy of impairment disclosures. ESMA is responsible, amongst other roles, for co-ordinating the activities of national regulators from the European Economic Area[1] (EEA) in respect of compliance with IFRS. The report and the related enforcement priorities of ESMA and the associated regulators only have direct relevance in the EEA, but when a body such as ESMA expresses concern, companies and their auditors pay attention. The report's results were not entirely unexpected. National regulators and academic research bodies, both within and outside the EEA have been making similar points about the disclosure of impairment since the beginning of the financial crisis.

The report noted that, "as a result of the financial and economic crisis, and the resulting poor economic outlook, assets in many industries may generate lower cash flows than expected when these assets were acquired. This has increased the likelihood that the carrying amount of the non-financial assets is greater than their recoverable amount and that impairment losses are required." However, the review did not find increased impairment losses. Instead, "significant impairment losses of goodwill recognised in 2011 were limited to a handful of issuers, particularly in the financial services and telecommunication industry." The accompanying press release noted that "this therefore raises the question as to whether the level of impairment disclosed in 2011 financial reports appropriately reflects the difficult economic operating environment for companies." Although information for 2012 is not yet available, economic conditions have not improved significantly and impairment disclosures remain highly relevant.

[1] The EU together with Iceland, Liechtenstein and Norway.

The report focuses on the quality of disclosures in the financial statements. It criticises some disclosures as being 'boilerplate', not entity-specific and, in some cases, not complying with the requirements of the standard. A study of impairment disclosures by Cass Business School found the same issue, "Compliance with impairment disclosures requiring greater managerial involvement in making discretionary reporting choices (high effort) is lower than compliance with low effort disclosure requirements, revealing a tendency to use boilerplate language."[2] This is important, if disclosures are not of sufficient quality, users of financial statements may be less likely to have confidence in the impairment test or the values attributed to goodwill and other assets.

The report sets out a number of observations for an entity using discounted cash flows (DCF) to test goodwill and indefinite-lived intangible assets for impairment, whether calculating value-in-use (VIU) or fair value less costs of disposal (FVLCD):

1. **Disclose key assumptions properly:** Key assumptions are those to which the recoverable amount of a cash generating unit (CGU) or CGU group is most sensitive. Key assumptions should relate clearly to an entity's activities. They include the discount rate and long-term growth rate, both of which have separate disclosure requirements.

   Management must disclose the approach it has taken to determine the underlying assumptions from which the cash flows are derived, e.g., assumptions about sales volumes, prices and margins and the extent to which they reflect past experience and external sources of information. If the assumptions differ from these sources, entities are asked to disclose how and why this has occurred. Projections often differ from past experience, e.g., because the entity is entering a new market or its activities are being prospectively affected by regulation; these factors will be built into the cash flows and should be disclosed.

2. **Be specific about the discount rates:** Entities must disclose the discount rates that apply to each CGU, or CGU group, to which a significant amount of goodwill or intangible assets with indefinite lives has been allocated. It is unlikely to be acceptable to disclose a range of discount rates for CGUs/CGU groups, nor would it be appropriate to disclose a single weighted average discount rate. Remember that this disclosure is based on the significance of the amount allocated to a specific CGU/CGU group compared to the total carrying amount of goodwill and indefinite-lived intangible assets.

[2] Cass Business School, *Accounting for asset impairment: a test for IFRS compliance across Europe*, January 2013.

3. **Take care with long-term growth rates:** IAS 36 states that, unless a higher rate can be justified, the growth rate must not exceed the long-term average for the products, industry or country. The ESMA report found a surprisingly high number of issuers using a growth rate of 3% or more (about a fifth) from a region that has seen little or no growth since 2008 and where there is little optimism about significant growth in the near future.

   The growth rate is determined depending on the sector and country concerned. Emerging economies may have high rates of growth, and growth in start-ups may be higher than in established technologies where the market may already be saturated. However, high growth rates are associated with high risks, which would entail a higher discount rate, at least in the shorter term.

4. **Improve the quality of disclosures about cash flows when applying FVLCD:** If entities use a DCF approach to calculate FVLCD, they must make similar disclosures to those for VIU (although the cash flows are not subject to the same restrictions). Entities need to disclose the period over which management has projected the cash flows, the growth rate used to extrapolate them and the discount rate. The key assumptions, management's approach to determining them and their level in the fair value hierarchy according to IFRS 13 *Fair Value Measurement* must always be disclosed, regardless of the method used to measure FVLCD. The IASB has recently increased the level of disclosure if there has been an impairment.[3]

5. **The sensitivity analysis should be relevant and realistic.** IAS 36 requires an entity to make additional disclosures if a "reasonably possible change in a key assumption" could reduce the recoverable amount to equal to the carrying amount, i.e., to erode all headroom. Crucially, sensitivity disclosures must be quantified. The entity must disclose the headroom and the value assigned to the key assumption and the amount by which that value must change. If, for example, budgeted earnings before interest, tax, depreciation and amortisation (EBITDA) is a key assumption, the carrying amount would be equal to the recoverable amount if EBITDA decreased from 11% to 8% of total revenue and this is a reasonably possible change, then these values must be disclosed. The past few years have shown that changes can be substantial and come about very quickly. Therefore, it is necessary to be realistic before asserting that no reasonably possible change in any key assumptions would erode the headroom.

   Although these disclosures are required for a single key assumption, after taking account of the consequential effects on other variables, entities may consider whether it is more meaningful to make similar disclosures for a combination of changes in key assumptions as well (i.e., scenario analysis). IAS 1 *Presentation of Financial Statements* requires entities to disclose sources of estimation uncertainty, i.e., assumptions that have a significant risk of resulting in a material adjustment to carrying amounts with the next financial year.

   Some entities show the effect of a percentage change to assumptions, e.g., a 10% decrease in sales volumes or 2% increase in discount rates. This is useful additional information to assist users in assessing the reliability of the impairment review, but it cannot be a substitute for the requirements in the standard if a reasonably possible change could lead to, or increase, an impairment charge.

The ESMA report was concerned that 43% of the sampled companies had a book value higher than their market capitalisation. A market capitalisation below book value will not necessarily be reflected in an equivalent impairment loss because of factors other than the return that the entity is generating on its assets. Entities do need to consider whether they should make greater disclosure to indicate why there is a shortfall as well as describing those factors that could result in impairment in the subsequent periods.

[3] *Recoverable Amount Disclosures for Non-Financial Assets* (amendments to IAS 36 *Impairment of Assets*) issued in May 2013.

IASB moving towards an improved IFRS framework

The *Conceptual Framework* forms the basis from which the International Accounting Standards Board (IASB, the Board) develops its individual IFRS standards. As a result of the feedback received on the Agenda Consultation in 2011, the Board restarted the *Conceptual Framework* project in September 2012. This project will build on the work previously done before the project was paused in 2010. It focuses on a number of aspects including: reporting entity; elements of financial statements; and measurement, presentation and disclosure. Figure 1 below provides a snapshot of the status and the plan for each individual topic within the framework.

Figure 1: Status and plan for the different topics in the *Conceptual Framework*

Topic within the *Conceptual Framework*	Status and plan
Objective and qualitative characteristics	Finalised in September 2010 and not intended to be revisited, except for consequential amendments
Purpose of *Conceptual Framework*	Update existing statement on purpose
Reporting entity	Build on the ED issued in March 2010
Elements (including, definitions of assets and liabilities, equity vs. liability, recognition and de-recognition)	Build on previous work
Measurement	Build on previous work
Presentation (including, presentation of profit or loss and other comprehensive income)	Build on the previous discussion in the *Financial Statement Presentation* project
Disclosures (including materiality)	Consider the feedback received in the disclosures forum

Since November 2012, the Board has been discussing various aspects of the framework. We speak to Stephen Cooper, member of the IASB since 1 August 2007, to get his thoughts on the importance of the project and the challenges faced.

As such, preparers need to follow the project as it will redefine the framework for IFRS and provide a sense of direction for the standards and interpretations. Indeed, it is important for the preparers and other constituents to provide feedback to the Board on the project.

Why do you think the *Conceptual Framework* is important for companies?

The IASB uses the *Conceptual Framework* as a guide for developing standards. For example, the IASB refers to the *Conceptual Framework* when considering whether an asset or liability should be recognised in the financial statements. So, the most effective way for preparers to have an active say in future standards is by participating now in the debate as the IASB works to improve the *Conceptual Framework*.

The *Conceptual Framework* also has a secondary role: preparers or companies refer to the *Conceptual Framework* for guidance in developing accounting policies when no standard specifically applies to a particular transaction.

Why is the Board focusing on the *Conceptual Framework* now?

In many cases, the *Conceptual Framework* has been a useful guide for the IASB. However, based on recent experience, the IASB felt that it could be improved. In its current form, it has some gaps as it says little about areas such as measurement, presentation and disclosure, or how to identify a reporting entity. In addition, the IASB believes it needs to clarify some areas of the *Conceptual Framework*. For example, the definitions of asset and liability could be clarified in the light of the IASB's experience in using the existing definitions.

In 2012, the IASB carried out a public consultation on its agenda. Many respondents to that consultation identified the *Conceptual Framework* as a priority project for the IASB. The IASB agreed with that assessment and recommenced active work on this project in the second half of 2012. In order to deliver an improved *Conceptual Framework* in a timely manner, the project focuses on targeted

improvements to address problems that have arisen when applying the existing *Conceptual Framework* in standards-level projects.

The IASB is planning to publish a discussion paper (DP) in July 2013 which will have a six-month comment period. The Board hopes the DP will trigger a lively debate to provide valuable input as it works towards an exposure draft of the improved *Conceptual Framework*.

What are some of the key challenges of the project?

One of the main challenges in the project, and something that I think many preparers would be interested in, is determining what is profit or loss and other comprehensive income (OCI), and whether recycling should be required or permitted.

Currently, there is no principle in IFRS to determine:

a) Which items of income or expense should be presented in profit or loss or in OCI
b) If and when items recognised in OCI should be recycled subsequently into profit or loss

We propose in the DP that all items recognised in the statement(s) of profit or loss and OCI provide some information about financial performance. In addition, we also think that many investors, creditors, preparers and others view profit or loss as a useful performance measure and that 'profit or loss' as a subtotal or a phrase is deeply ingrained in the economy, business and investors' minds. Users from all sectors incorporate profit or loss in their analyses, either as a starting point for analysis or as the main indicator of an entity's performance. Consequently, we are proposing that the *Conceptual Framework* should retain the concept of profit or loss as an important subtotal. We are also proposing to provide guidance on what OCI is considered to be; the residual is then profit or loss. We are proposing two approaches on how to describe OCI – whether it should be a narrow approach that reflects some remeasurements for a limited set of items, or a broader approach that offers more flexibility on what can be classified as OCI.

What's next

The DP is expected to be issued in July 2013 and the IASB expects to provide a six-month comment period.

Stephen Cooper

Stephen Cooper has been a member of the IASB since 2007, having previously served on a number of its advisory groups, including the joint international group advising the IASB and FASB on financial statement presentation. He was also a member of the IASB's investor advisory group from its inception, now called the capital markets advisory committee. Prior to joining the IASB, Mr Cooper was a Managing Director in the equities division of UBS Investment Bank. Mr Cooper has also held other investment banking-related roles including corporate finance advisory and financial analysis education and training. Mr Cooper qualified as an accountant in 1983 and has a Master's degree in Accounting and Finance from the London School of Economics.

IFRS project update

What's new?

The following table shows key new publications issued by the IASB since the last edition of *IFRS Outlook*.

Projects	Publication
***Recoverable Amount Disclosures for Non-Financial Assets* (Amendments to IAS 36)**	In June 2013, the IASB issued amendments to IAS 36 *Impairment of Assets* relating to disclosures in respect of fair value less costs of disposal.
***Novation of Derivatives and Continuation of Hedge Accounting* (Amendments to IAS 39)**	In June 2013, the IASB issued amendments to IAS 39 *Financial Instruments: Recognition and Measurement* that provides a narrow exception to the requirement for the discontinuation of hedge accounting in circumstances when a hedging instrument is required to be novated to a central counterparty as a result of laws or regulations.
IFRIC Interpretation 21 *Levies*	In May 2013, the IASB issued IFRIC Interpretation 21 *Levies*, which clarifies the accounting for levies imposed by governments.
Exposure draft *Insurance Contracts*	The IASB issued for public comment a revised exposure draft (ED) of proposals for the accounting for insurance contracts. The ED is open for comment until 25 October 2013 and can be accessed at www.ifrs.org/Current-Projects/IASB-Projects/Insurance-Contracts/Exposure-Draft-June-2013/Pages/Exposure-Draft-and-comment-letters.aspx
Exposure draft *Leases*	In May 2013, the IASB and the FASB issued exposure drafts proposing a right-of-use model for leases that would require lessees to recognise most leases on their balance sheets. Lessor accounting would also be affected. The ED is open for comment until 13 September 2013 and can be accessed at www.ifrs.org/Current-Projects/IASB-Projects/Leases/Exposure-Draft-May-2013/Pages/ED-and-comment-letters.aspx
Exposure draft *Regulatory Deferral Accounts*	In April 2013, the IASB issued an exposure draft *Regulatory Deferral Accounts* proposing an interim standard to encourage adoption of IFRS in jurisdictions that currently allow, or require, the recognition of rate-regulated assets and liabilities. The ED is open for comment until 4 September 2013 and can be accessed at www.ifrs.org/Current-Projects/IASB-Projects/Rate-regulated-activities/Exposure-Draft-April-2013/Documents/ED_Regulatory-Deferral%20Account.pdf

Current discussions

The IASB is preparing to issue the final standard on revenue in Q3 2013. It has been deliberating a number of other topics, including: the conceptual framework, financial instruments: classification and measurement and annual improvements projects.

The IFRS Interpretations Committee last met on 14-15 May 2013 to deliberate on a number of issues, including:

- Recognition of deferred tax for unrealised losses
- Reissuing previously issued financial statements
- Protective rights and continuous assessment of control under IFRS 10
- Application of transfers of financial assets disclosures to servicing rights/obligations
- Classification in conjunction with a planned IPO and change in disposal method
- Fair value measurement of portfolios of financial instruments

Updates from the IASB and the Interpretations Committee meetings can be found at www.ifrs.org/Updates

IASB work plan

The IASB last updated its work plan on 21 June 2013. Milestones on a number of projects are expected in Q3 2013, including:

- Final standard on revenue and hedge accounting amendments to IFRS 9
- Exposure drafts on proposed amendments: discount rate under IAS 19 *Employee Benefits*; bearer plants; fair value measurement; put options written on non-controlling interests and separate financial statements (equity method)
- Discussion papers on macro hedge accounting and conceptual framework

The work plan can accessed at www.ifrs.org

Resources

The following is a list of IFRS publications issued since the last edition of *IFRS Outlook*. The publications are all available at www.ey.com/ifrs..

IFRS Developments: Issues 56 — 62

Issue 56: IASB to clarify interaction between unit of account and fair value measurement requirements

This issue summarises the IASB's tentative decisions to clarify the unit of account for investments in subsidiaries, associates and joint ventures, and clarifications on the interaction between that unit of account and the fair value measurement requirements in IFRS 13 *Fair Value Measurement*.

Issue 57: IASB concludes its re-deliberations on hedge accounting project

This issue summarises the IASB's re-deliberations on the hedge accounting project, which is the third phase of the overall project to replace IAS 39.

Issue 58: Boards issue revised proposal to put most leases on the balance sheet

This issue summarises the revised proposal on lease accounting re-exposed by the Boards.

Issue 59: IASB issues IFRIC Interpretation 21 Levies

This issue summarises IFRIC Interpretation 21 *Levies*, which clarifies the accounting for levies imposed by governments.

Issue 60: Revenue recognition - credit card rewards and transition

This issue summarises the Boards' discussions on accounting for credit card reward transactions and transition requirements for first-time adopters of IFRS that adopt the new revenue standard.

Issue 61: IASB proposes an interim standard on regulatory deferral accounts

This issue summarises the IASB exposure draft proposing an interim standard to encourage adoption of IFRS in jurisdictions that currently allow, or require, the recognition of rate-regulated assets and liabilities.

Issue 62: Amendments to IAS 39: Continuing hedge accounting after novation

This issue summaries the amendments to IAS 39 that provides a relief from discontinuing hedge accounting when novation of a derivative designated as a hedging instrument meets certain criteria.

Applying IFRS

Applying IFRS: IFRS 12 Disclosures of Interests in Other Entities

This edition focuses on the disclosure requirements in IFRS 12 *Disclosures of Interests in Other Entities* that apply to interests in unconsolidated structured entities and includes illustrative examples.

Applying IFRS in Life Sciences: Accounting for collaborations in the life sciences sector — Challenges in applying IFRS 10 and IFRS 11

This editio focuses on accounting for collaboration arrangements under IFRS 10 *Consolidated Financial Statements* and IFRS 11 *Joint Arrangements*.

Other publications

IFRS Developments for Mining & Metals: Acquisitions of interests in joint operations that are businesses

This edition takes a closer look at the accounting for joint arrangements in the mining and metals sector under IFRS 11, which became effective on 1 January 2013.

IFRS Developments for Oil & Gas: Acquisitions of interests in joint operations that are businesses

This edition takes a closer look at the accounting for joint arrangements in the oil and gas sector under IFRS 11, which became effective on 1 January 2013.

IFRS Practical Matters: Leases re-exposed: Another attempt at improving lease accounting

This publication analyses the high-level impacts the IASB's revised leases exposure draft could have on companies' finance, tax, IT and business processes.

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About EY's International Financial Reporting Standards Group
The move to International Financial Reporting Standards (IFRS) is the single most important initiative in the financial reporting world, the impact of which stretches far beyond accounting to affect every key decision you make, not just how you report it. We have developed the global resources — people and knowledge — to support our client teams. And we work to give you the benefit of our broad sector experience, our deep subject matter knowledge and the latest insights from our work worldwide. It's how EY makes a difference.

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