



2011 Bahamas Institute of Chartered Accountants *Accountants' Week*

Technical Update

10 November 2011



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Agenda

- **Introduction and Refresher Questions**
- **Recently Issued Standards**
 - Consolidation and Joint Arrangements
 - Financial Instruments Update
 - Fair Value
 - Other Recently Issued Standards
- **Proposed Standards**
 - IASB Project Plan
 - Recent Exposure Drafts



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Introduction and Refresher Questions



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2011: The Year of the Perfect “Accounting” Storm

Response to the Financial Crisis

Convergence Roadmap/ SEC Decision on Acceptance of IFRS

Outdated Standards and Pressures over “Worldwide Acceptance” of IFRS

2011

IASB Board Scheduled Turnover

Regulatory Environment: Basel 2, Solvency 2, Dodd-Frank, etc.



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The Winds of Change

Financial Instruments (includes
Classification & Measurement,
Impairment, and Hedge
Accounting)

Fair Value

Consolidation & Joint Arrangements

Employee Benefits

Significant Exposure Drafts
(Revenue Recognition, Leases,
Insurance and Investment
Entities)



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Refresher Question: Consolidation ⁽¹⁾

Entities Chocolate and Cheese own 55% and 45%, respectively of the ordinary shares that carry voting rights at a general meeting of shareholders of Alpine AG. Cheese also holds debt instruments that are convertible into ordinary shares of Alpine AG. The debt can be converted at a substantial price, in comparison with Cheese's net assets, at any time and if converted would require Cheese to borrow additional funds to make the payment. If the debt were to be converted, Cheese would hold 70% of the voting rights and Chocolate's interest would reduce to 30%.

Who should consolidate Alpine AG under current IFRS?



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Refresher Question: Consolidation ⁽²⁾

Laurel, a listed entity, holds 42% of the voting shares of Hardy, which is also listed. The remaining voting shares are widely held. Laurel has four seats on Hardy's ten-seat board of directors.

How should Laurel account for its investment in Hardy?



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Refresher Question: Classification and Measurement of Financial Assets under IFRS 9

1. Investment in a 8% General Electric bond, intended to be held until maturity
2. Investment in General Electric shares, intended to be held for the long-term
3. Investment in Google shares, intended to be sold in the near term for profit
4. Interest rate swap
5. Equity-linked debt security (bond with embedded equity options), intended to be held to maturity

How would the above instruments be classified and measured under IFRS 9?



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Refresher Question: Impairment of Debt Securities

Speedy Gonzalez purchased several debt instruments on 1 January classified as available-for-sale under current IAS 39 classification guidance. On the date of acquisition, the debt securities had an effective interest rate of 7%. However, due to repeated increases in the federal borrowing rate over the past few years, the interest rates for similar securities have increased to 14%. As a result, the fair value of Speedy's bonds have decreased substantially.

Do the debt securities have objective evidence of impairment based on the information provided?

Assume Speedy has the intention to sell the securities due to interest rate changes. Would this result in an impairment being recognised?

What if the decline in fair value was due to a decline in the bond's credit rating? Would this be objective evidence of impairment?



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Refresher Question: Leases

Ranger, Inc. leases a piece of equipment from Cardinal Co. for use in their operations. The equipment has a useful life of 10 years and a fair value at lease inception of USD 1 million. The lease is a 7 year lease and the present value of future minimum lease payments totals USD 850,000. The title for the equipment does not pass to Ranger at the end of the lease. However, Ranger can purchase the machine at the end of the lease for its fair value.

How should Ranger classify this lease?



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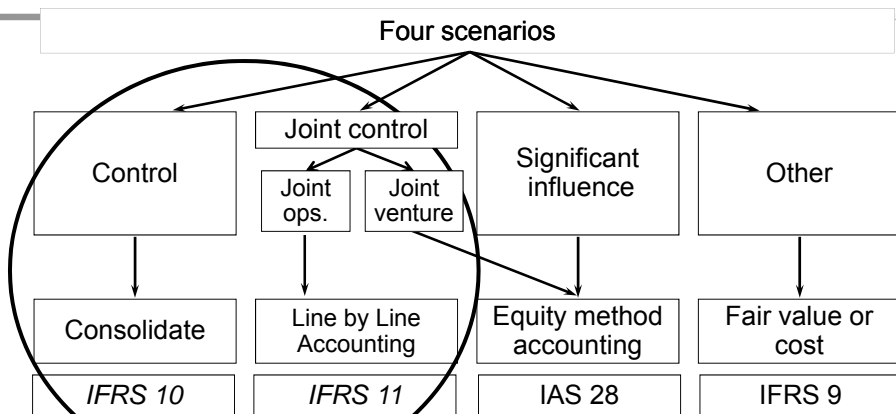


Consolidation and Joint Arrangements



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Introduction: Influence Over Investments



* IFRS 12, Disclosure of Interests in Other Entities will also be discussed in this module.

Covered in this module!*

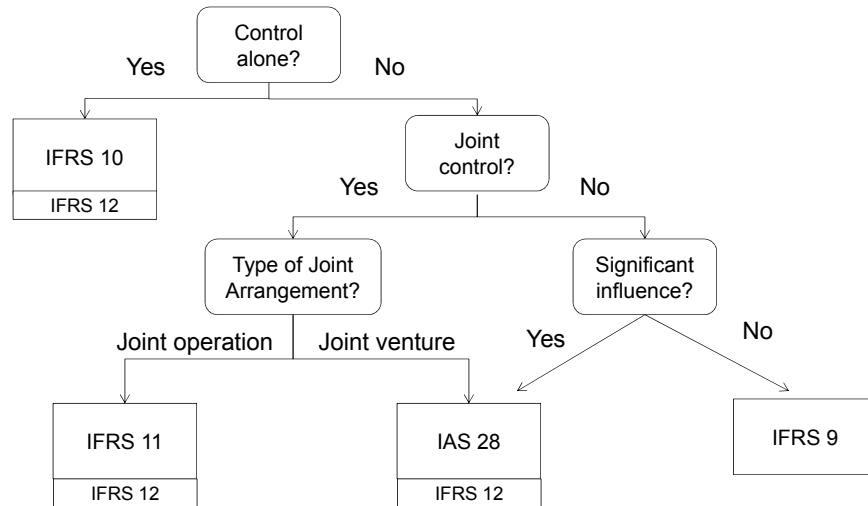


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Introduction: Interaction between IFRS 10, IFRS 11, IFRS 12 and IAS 28



Newsflash: IASB Issues ED for Consolidation Exemption for Qualified Investment Entities



“This initiative is another step by the IASB in aligning the way investments are managed and their performance evaluated internally with external financial reporting. This could be a significant, positive change compared with the current position of IFRS. Investment companies that qualify for the exemption could benefit from the amendments, not least by avoiding the cost of consolidating controlled investments.” *(Wm David Seymour, KPMG’s Global Head of Investment Management)*

“Not all investment companies will qualify for the exemption. There are a number of criteria to be met, which means that companies should carefully consider the proposals specific circumstances. As an example, the companies *only* substantive activities must be investing in multiple investments for capital appreciation and/or investment income; this means that some investment companies that take a more active role with respect to their investees may not qualify. This will certainly be something for the private equity sector in particular to look at very carefully.” *(Paul Munter, KPMG’s Global IFRS Consolidations Leader)*



Overview and Objectives

- **Objectives:**
 - To specify the criteria for determining when an entity is an investment entity; and
 - To specify how an investment entity shall account for its investments
- **Key provisions:**
 - Defines an investment entity and provides specific criteria for determining when an entity is an investment entity
 - Requires that investment entities NOT consolidate entities they control, rather they measure these entities at fair value through P&L under IFRS 9
 - Requires that a parent of an investment entity continue to consolidate all entities that it controls, including those controlled through an investment entity, unless the parent itself is an investment entity
 - Provides additional disclosure requirements for investment entities



**Effective date = ??? (The IASB has not yet proposed an effective date).
Comments are due on the exposure draft by 5 January 2012.**

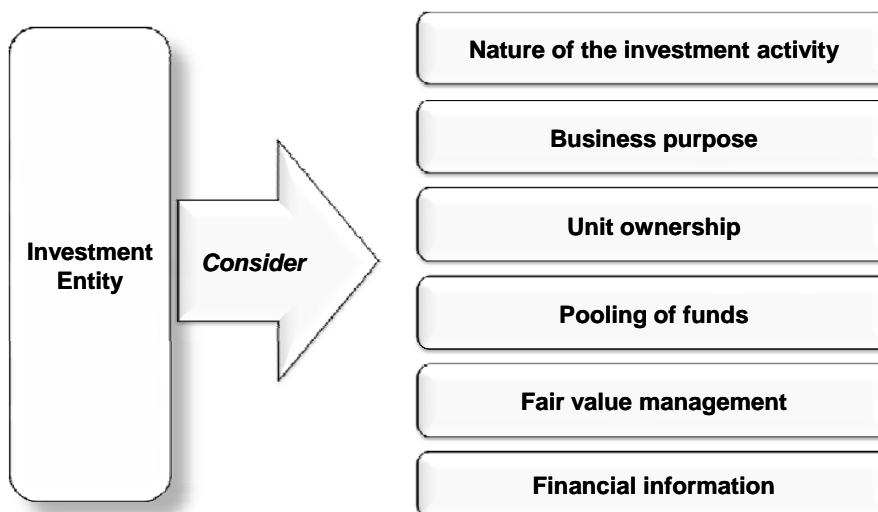


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Criteria for Determining an Investment Entity

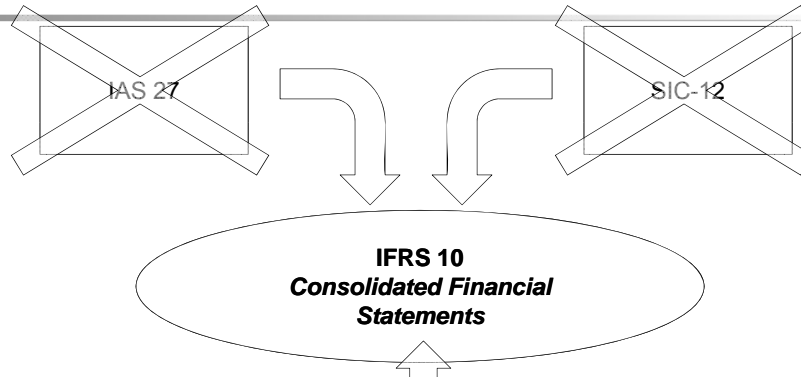


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Introduction to IFRS 10



Establishes single "control model" for all types of entities and will replace previous consolidation standards!

IFRS 10 is effective for fiscal periods beginning on or after 1 January 2013.



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Introduction to the Definition of Control in IFRS 10

IFRS 10 Definition of Control = "An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee."



- Power requires the investor to have existing rights that give it the *current ability* to direct the activities that significantly affect the investee's returns
- Power is based on *ability*, meaning that power does not need to be exercised

The assessment of control is made on a continuous basis. The investor must reassess whether it controls an investee if facts and circumstances indicate that there are changes to one or more elements of control.



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Key Changes from Previous Practice

Key Changes:

- Judgmental approach
- Single control model applies to all investees
- Identification of investee activities is explicitly required
- De facto control is included in the model
- Control is assessed based on substantive potential voting rights as opposed to currently exercisable potential voting rights
- Exposure or right to variability in returns replaces the concept of benefits
- Principal vs. agent guidance is explicitly introduced
- Guidance provided on when an investor would assess power over silos instead of over a legal entity
- Protective rights are defined and explicit guidance on kick-out rights is introduced
- More disclosures about consolidated and unconsolidated entities are required

These changes will be highlighted throughout the module.



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Navigating the New Consolidation Model

Step 1: Identify the investee and the relevant activities of the investee

Step 2: Identify how decisions about the relevant activities are made

Step 3: Assess whether the investor has power over the relevant activities

Step 4: Assess whether the investor is exposed to variability in returns

Step 5: Assess whether there is a link between power and returns



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Step 1a: Identify the Investee

Control is generally assessed at the level of the legal entity

In certain cases, however, an investor has power over only specified assets and liabilities of an entity and treats that portion of the entity as a separate entity called a “silo”. IFRS 10 can only be applied to a silo if:

- In substance, the assets, liabilities, and equity of the silo are separate from the overall entity, and:
 - None of those assets can be used to pay other obligations of the entity
 - The assets are the only source of payment for specified liabilities of the silo
- Parties other than those with the specified liability have no rights or obligations related to the specified assets or to residual cash flows from those assets

IFRS 10 does not define the terms “investor” and “investee” and these terms are used interchangeably in situations when the investor has control over the investee and when the investor does not have control over the investee.



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Step 1b: Identify the Relevant Activities of the Investee ⁽¹⁾

Relevant activities = activities of the investee that significantly affect the investee's returns

Considerations:

- Range of operating and financing activities significantly impacting returns
- Several investors each direct relevant activities (see example on next slide)
- Relevant activities occur when particular circumstances or events occur

Significant judgment is required when determining the activities that significantly affect the returns of the investee, particularly when an entity has “predetermined” activities.

This assessment is critical because an investor “has power over an investee when the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns (“the relevant activities”). Power is one of the three key elements of control.



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Class Discussion: Identify the Relevant Activities of the Investee

Rossdale Financial and Stefani Bank form an investee, Kingston Trust with the purpose of purchasing a portfolio of asset-backed securities with varying lives and interest rates. The arrangement will be marketed to potential investors as an investment in a portfolio of asset-backed securities with exposure to credit-risk (from default) and interest rate risk (from portfolio management). The trust is financed through the issuance of debt securities and equity.

Rossdale has the unilateral ability to make decisions related to the financing of the trust and is solely responsible for this activity. Stefani has the unilateral ability to make decisions about portfolio management of the asset backed securities and is solely responsible for this activity. All of the describe activities are “relevant” activities.

Which investor has the power (i.e. has the current ability to direct the activities that most significantly affect the returns of the investee)?



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Step 1b: Identify the Relevant Activities of the Investee (2)

There is no clear answer based on the limited facts given in this case. This is an area under the new standard where significant judgment will be required. Each investor needs to determine the activity that most significantly affects the investee's returns, considering the following factors:

- The purpose and design of the investee
- The factors that determine profit and value of the investee
- The effect of each investor's decision making authority on the investee's returns
- The investor's exposure to variability of returns
- The uncertainty of and effort required to obtain financing

The conclusion reached in respect of which investor has power should be valid for the whole of the life of the arrangement and not just at one moment in time, unless facts and circumstances change. This means that power does not shift simply because the activities of the entity change throughout the life cycle of the entity.



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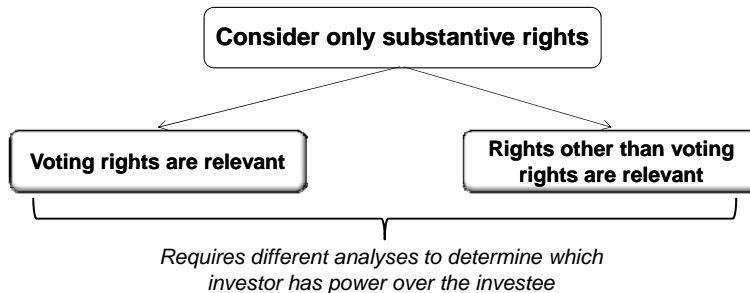


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Step 2: Identify How Decisions about the Relevant Activities are Made ⁽¹⁾



“Gating” question – Are voting rights relevant in assessing whether the investor has power over the investee (meaning the investee is controlled by voting instruments) or are voting rights not relevant in assessing whether the investor has power over the investee (meaning the investee is controlled by means of other rights)?



The gating question is subject to continuous assessment.



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Step 2: Identify How Decisions about the Relevant Activities are Made ⁽²⁾

- For purposes of answering the “gating” question and assessing power, only substantive rights are considered
- IFRS 10 explicitly requires consideration of both substantive rights held by the investor and held by others
- To be substantive, rights must be exercisable when decisions about the relevant activities need to be made, and the holder must have practical ability to exercise those rights
- Substantive rights exercisable by other parties can prevent an investor from controlling the investee – this is why rights held by all parties must be considered!
- Judgment must be applied and consideration should be given to:
 - Whether there are barriers that prevent the holder from exercising the rights
 - Whether several parties need to agree for the rights to become exercisable or operational
 - Whether the party that holds the rights would benefit from their exercise
- Protective rights are different from substantive rights because they do not give the holder power to control the investee

What are some examples of “barriers that prevent the holder from exercising rights”?



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Class Discussion: Determining Whether Rights are Substantive

Sunbeam, an investee whose activities are controlled through voting rights, has annual shareholder meetings at which decisions to direct the relevant activities of the entity are made. The next shareholder meeting is scheduled for 9 months time. However, shareholders can call a special meeting to change the existing policies over relevant activities, but a requirement to give notice to the other shareholders means that such a meeting cannot be held for at least 30 days.

Scenario 1

Investor Alpine holds the majority of the voting rights in Sunbeam.

Scenario 2

Investor Rapiet holds an option to acquire the majority of the shares in Sunbeam. The option is exercisable in 25 days and is deeply in the money.

Scenario 3

Investor Tiger is party to a forward contract to acquire the majority of the shares in Sunbeam. The forward contract's settlement date is in six months.

Consider each scenario above in isolation. Are the voting rights substantive?



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Class Discussion: Substantive vs. Protective Rights

Nat King owns 60% of the voting shares of Unforgettable, with the other 40% owned by Cole. In accordance with the articles of incorporation, Cole can effectively block the following corporate actions (even though it doesn't control more than 50% of the voting shares):

- Amendments to the articles of incorporation of Unforgettable
- Liquidation of Unforgettable
- Pricing of related party transactions
- Issuance or repurchase of Unforgettable voting shares
- Incurrence of additional indebtedness by Unforgettable

Are these rights considered substantive? (i.e. do they give Cole "the power" and therefore control over Unforgettable?)



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Step 3: Assess Whether the Investor has Power Over the Relevant Activities



- An investor has the power over an investee when the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns
- As discussed in the last step, only substantive rights are considered and the “gating question” is whether:
 - Voting rights are relevant, or
 - Rights other than voting rights are relevant
- Different analyses are performed to assess which investor has power over the investee depending on the answer to the “gating question”

The assessment of control when voting rights are relevant or when rights other than voting rights are relevant will be discussed on subsequent slides.

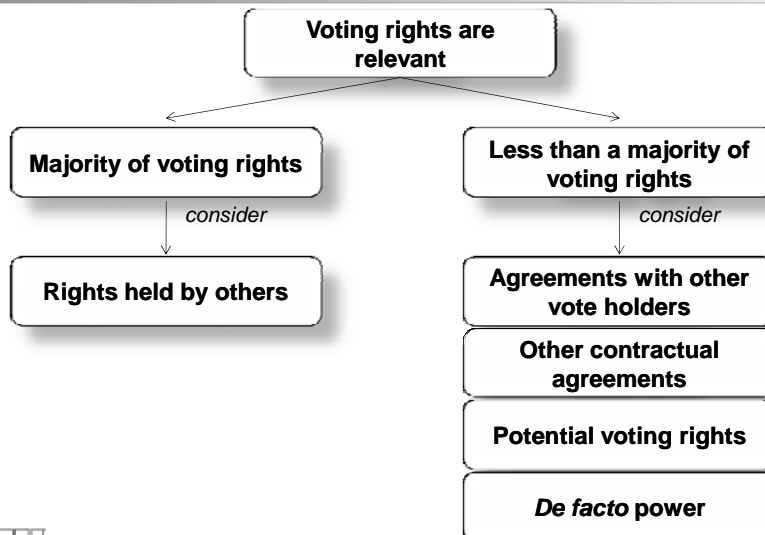


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Voting Rights are Relevant



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Class Discussion: Potential Voting Rights

At 31 December 2011, Lucky Charms LLC holds a 40% interest in Sugar Smacks Inc. In addition to this voting interest, Lucky Charms has an option to acquire an additional 15% of Sugar Smacks from Silly Rabbit Advisors at anytime over the next 10 years.

Does Lucky Charms control Sugar Smacks on 31 December 2011?

Assume the option to acquire the additional 15% is not exercisable until 2015. How does this affect control?

Assume the option to acquire the additional 15% is deeply out of the money. How does this affect control?

Assume Silly Rabbit is the investment advisor who manages Lucky Charms' investment portfolio, acting as their agent in various investment transactions.

How does this information impact the control assessment?



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Class Discussion: De Facto Power

Yoko, a listed entity, holds 47% of the voting shares of John, which is also listed. The remaining voting shares are widely held by thousands of shareholders each holding no more than 1% of voting shares. There are no agreements between the remaining shareholders.

Does Yoko have control over John and therefore should consolidate?

Linda, a listed entity, holds 42% of the voting shares of Paul, which is also listed. Two other shareholders unrelated to Linda each hold 27% of the voting rights of Paul. The remaining voting shares are widely held. There are no agreements between the remaining shareholders to be considered.

Does Linda have control over Paul and therefore should consolidate?

Patti, a listed entity, holds 30% of the voting shares of George, which is also listed. Three other investors each hold 9% of the voting rights of George. The remaining 43% of voting shares are widely held with no investor holding more than 1% of voting shares.

Does Patti have control over George and therefore should consolidate?



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Rights Other than Voting Rights are Relevant

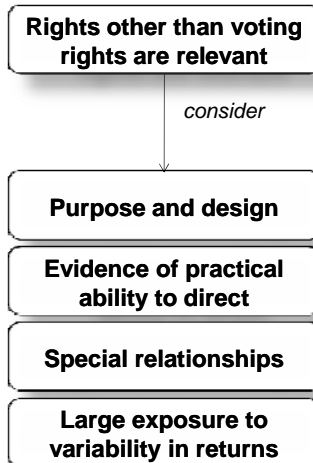
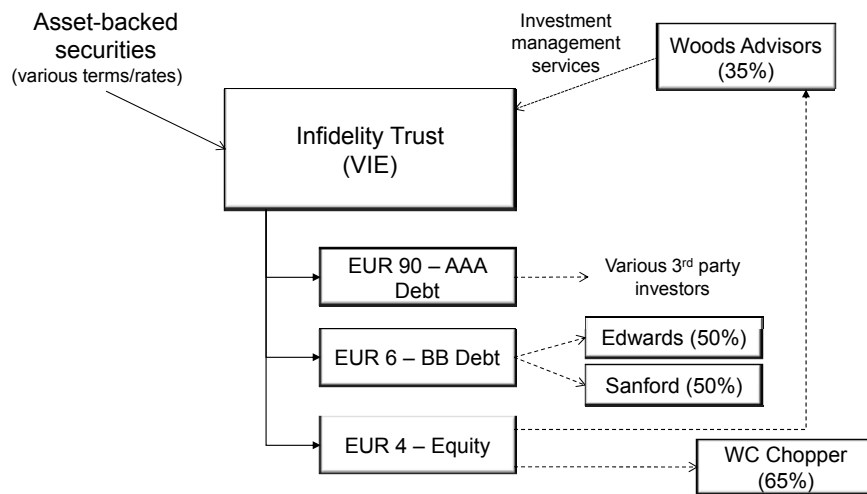


Illustration of Arrangement for Subsequent Class Discussions



Class Discussion: Consolidation of SPEs under IFRS 10 ⁽¹⁾

Infidelity Trust, an SPE, is created and financed through the issuance of EUR 90 of AAA-rated and EUR 6 of BB-rated fixed debt securities and EUR 4 of equity. All of the AAA-rated debt securities are held by various third-party investors, the BB-rated debt securities are held 50% each by Edwards and Sanford (third parties), while the equity is held 35% by Woods Advisors and 65% by WC Chopper (third party). Infidelity uses this financing to purchase a portfolio of asset-backed securities with varying lives and interest rates.

The arrangement was marketed to potential debt investors as an investment in a portfolio of asset-backed securities with exposure to credit-risk (from default) and interest-rate risk (from portfolio management). The equity tranche was designed to absorb the initial losses from the investments, while also receiving any residual returns from a favourable change in interest rate and credit risk.

Woods Advisors is the investment manager responsible for all investment decisions and earns a base fixed fee as well as a performance fee (based on a portion of the entity's profit above a specified target return).

Based on the facts presented, which entity would most likely be responsible for the consolidation of Infidelity Trust?



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Class Discussion: Consolidation of SPEs under IFRS 10 ⁽²⁾

Using the facts from the previous example, assume that under the terms of the contract, Woods Advisors is only responsible for the management of “performing” asset-backed investments. Any investments held by Infidelity that become “nonperforming” (defined as more than 45 days past due), are required to be segregated from Woods’ investment portfolio and put under the control of Spitzer Credit Specialists (SCS). SCS is responsible for servicing these nonperforming assets and making the necessary decisions regarding work-outs, modifications, or foreclosures. WC Chopper has the unilateral authority to remove and replace SCS under the agreement.

How does this additional information regarding the arrangement impact determination of the consolidating entity?



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Step 4: Assess Whether the Investor is Exposed to Variability in Returns

Returns from involvement with an entity vary with that entity's activities and may be positive or negative

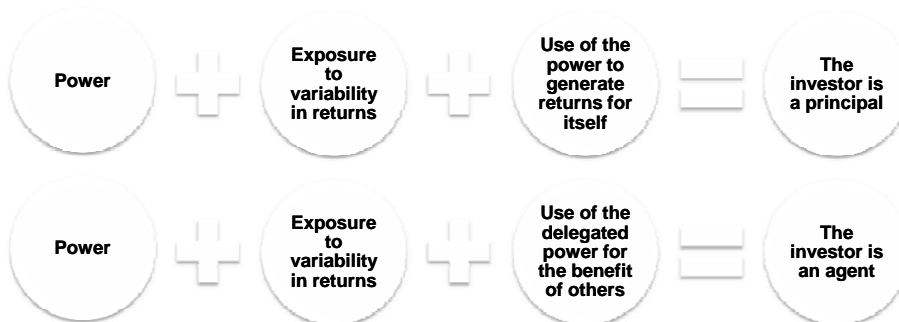
An investor assesses whether returns are variable, and how variable those returns are based on the substance of the arrangement

Returns can include:

- Dividends, other distributions of economic benefits (e.g. interest) and changes in the value of the investor's investment in the investee
- Remuneration for servicing an investee's assets or liabilities, fees and exposure to loss from providing credit or liquidity support, etc.
- Returns that are not available to non-controlling interests (e.g. combining functions to achieve economies of scale, access to proprietary knowledge)
- Cost savings or reduction of expenses

Step 5: Assess Whether there is a Link Between Power and Returns

- In addition to *power* and *exposure to variability in returns*, an investor must also have the ability to use its power over the investee to affect its returns in order to have control. This means a *link between power and returns* is required.
- IFRS 10 only illustrates one example where an investor has power and returns but does not have a link between power and returns. This is when the investor is an *agent*.
- An *agent* does not control an investee.



Principal vs. Agent Determination

If a single party holds substantive rights to remove the decision maker without cause then the decision maker is an *agent*.

Otherwise the decision maker must consider the overall relationship between itself and other parties and consider the following factors in determining whether it is an agent:

- The scope of its decision-making authority over the investee
- The rights held by other parties, including substantive removal rights not held by a single party
- Its remuneration (level of linkage with the investee's performance), and
- Its exposure to variability of returns because of other interest that it holds in the investee

Different weightings are applied to each of the factors depending on the specific facts and circumstances.



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Class Discussion: Agency Relationships

Based on the previous example, could it be argued that Woods Advisors, in its role as investment manager, is acting as an "agent" for the other investors?

Assume the SPE arrangement contractually provides WC Chopper (on its own) the right to remove Woods Advisors as investment manager. How does this impact the assessment of consolidation?

Assume that Woods Advisors could be removed from its position as investment manager through a majority vote of all debt and equity holders. How does this impact the assessment of consolidation?

Remember that Woods earns a base fixed fee as well as a performance fee (based on a portion of the entity's profit above a specified target return). How does this fee impact the decision about whether Woods is acting as a principal or an agent?



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Consolidation Procedures

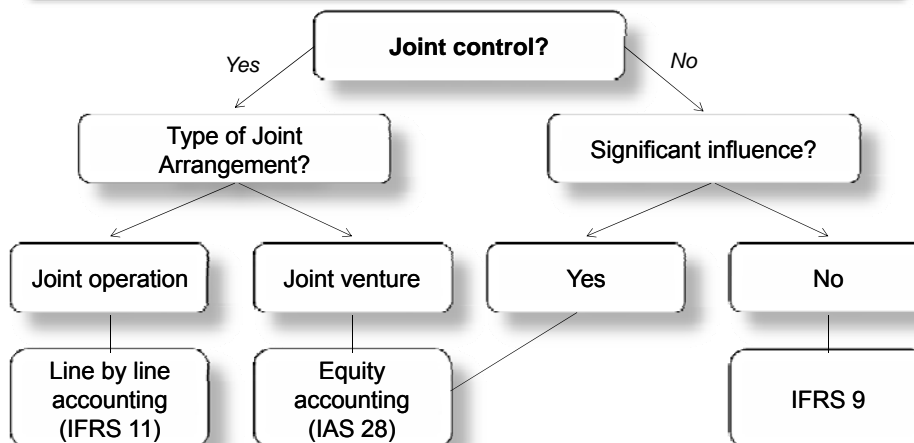
Once the conclusion has been reached that consolidation of an investee is required, IFRS discusses the following requirements (summarised):

- The use of uniform accounting policies
- The elimination of intergroup transactions
- The reporting period
- Non-controlling interests (NCI)
- The loss of control
- Present access to economic benefits in IAS 27/current access to returns in IFRS 10

These requirements are substantially the same in IAS 27 and in IFRS 10.

Overview of IFRS 11 Joint Arrangements

Joint arrangement = an arrangement over which there is joint control



Identifying Joint Arrangements

Definition of a joint arrangement

- An arrangement over which two or more parties have joint control, being the contractually agreed sharing of control, i.e. unanimous consent is required for decisions about the relevant activities

Control = IFRS 10 definition

- An investor controls an investee when it is exposed or has rights to variable returns from its involvement with that investee and has the ability to affect those returns through its power over the investee

Joint control

- The contractually agreed sharing of control of an arrangement which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control

IFRS 11 discusses performance of a two-step analysis:

- Assess whether collective control exists of an arrangement
- Assess whether the contractual arrangement gives two or more parties joint control over the arrangement

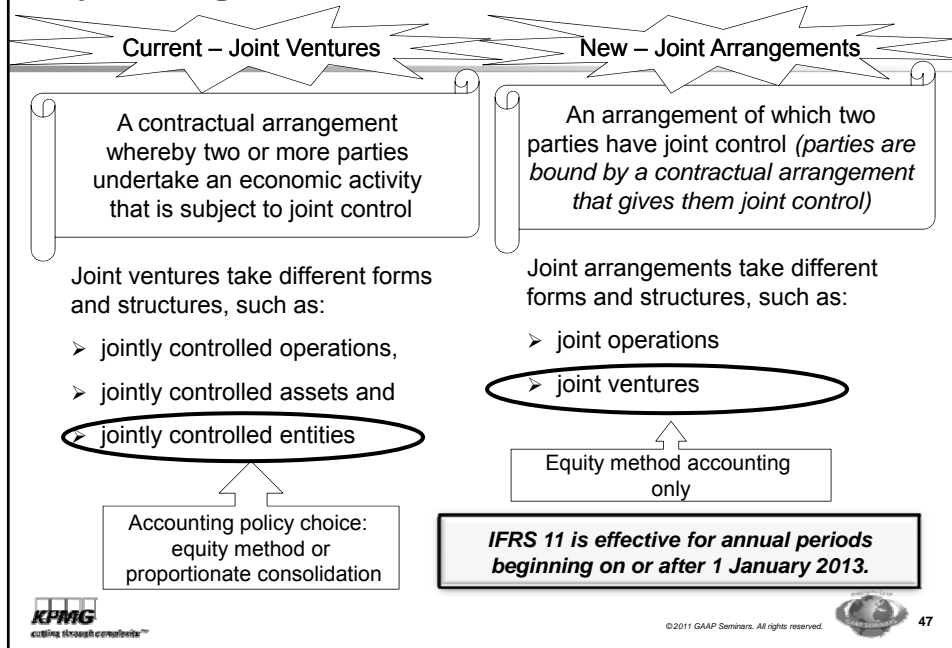
Not all parties to the arrangement need to share control over the arrangement for it to be considered a joint arrangement. IFRS 11 specifies the accounting for parties that have joint control and also for those that participate in, but do not have joint control over the arrangement.

Class Discussion: Identifying Joint Arrangements

Barry, Robin and Maurice establish Staying Alive LLC, an entity specialising in the sale of survival and disaster readiness equipment. Based on the contractual terms of their agreement, each investor receives an equal one-third interest in the organisation, which includes both returns and voting rights. All operational and strategic moves are decided by a majority vote by the investors.

Is Staying Alive a joint arrangement within the scope of IFRS 11?

Key Changes from Current Practice



Classifying Joint Arrangements

Joint arrangements are classified as either:

- **Joint operation** – an arrangement where the jointly controlling parties (the “joint operators”) have rights to the assets and obligations for the liabilities relating to the joint arrangement
- **Joint venture** – an arrangement where the jointly controlling parties (the “joint venturers”) have rights to the net assets of the arrangement

The key to determining the type of arrangement is the rights and the obligations of the parties arising from the arrangement in the normal course of business

An entity determines the type of joint arrangement by considering:

- The structure
- The legal form
- The contractual arrangement
- Other facts and circumstances



Each type of joint arrangement has its own accounting model.

IFRS 12 *Disclosure of Interest in Other Entities: Overview*

Applies to entities that have an interest in a subsidiary, joint arrangement, an associate, or an unconsolidated structured entity (USE)

- Integrates disclosure requirements for IAS 27 (IFRS 10), IAS 28 and IAS 31 (IFRS 11) and USEs

Issued in response to the global financial crisis and input from the G20 and Financial Stability Forum (FSF)

- Highlighted lack of transparency about risks to which an entity was exposed from its involvement in structured entities, including those it had sponsored

Requires disclosures about:

- Significant judgments and assumptions it has made in determining the nature of its interest in another entity or arrangement, and in determining the type of joint arrangement in which it has an interest; and
- Information about interests in subsidiaries, joint arrangements, associates, and structured entities that are not controlled by the entity (i.e. USEs)

Disclosures under IFRS 12 may be aggregated for interests in similar entities, with the method of aggregation disclosed

**IFRS 12 is effective for fiscal years beginning on or after 1 January 2013.
Early application is permitted and encouraged.**



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IFRS 12: Definition of Structured Entities

Special Purpose Entities (SPEs)

IFRS 12 replaces the term "SPE" with "structured entity"

Structured Entities

An entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements

This definition is important because IFRS 12 requires additional disclosures for structured entities, particularly those that are not consolidated.



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IFRS 12: Key Disclosures



Interests in Subsidiaries

- Certain information about interests that non-controlling interests have in the group's activities and cash flows (material to the reporting entity)
- Nature and extent of significant restrictions on investor's ability to access or use assets and settle liabilities
- Changes in ownership interests in a subsidiary

Unconsolidated Structured Entities

- Information that enables users of its financial statements to understand the nature and extent of its interests in unconsolidated structured entities (USEs) – *qualitative and quantitative*
- Certain information if during the period the entity has, without having a contractual obligation to do so, provided financial or other support to a USE in which it previously had or currently has an interest
- Current intentions an entity has to provide financial or other support to a USE

Joint Ventures

- Information on the nature, extent and financial effects of interests in joint arrangements
- Quantitative disclosures that include summarized financial information for specified items
- For all individually immaterial joint ventures and associates, certain aggregate information must be disclosed (separately for JVs and associates)

Class Discussion: Impact of IFRS 12



What impact do you think the adoption of IFRS 12 will have on your company?



Financial Instruments Update



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IFRS 9: Measurement of Financial Liabilities

All financial liabilities subsequently measured at amortised cost using the effective interest method except:

| <i>Held for Trading</i> | <i>FVO</i> | <i>Other</i> |
|---|---|---|
| <ul style="list-style-type: none"> • Short term buying and selling • Derivatives • On initial recognition is part of a portfolio managed together and for which there is evidence of a recent actual pattern of short-term profit taking | <ul style="list-style-type: none"> • Significantly reduces an accounting mismatch • Part of a group of financial instruments that are managed and evaluated on a fair value basis • Hybrid instrument that would require bifurcation | <ul style="list-style-type: none"> • Financial guarantee contracts • Commitments to provide loans at below market rates • Liabilities arising on transfers of financial assets that do not qualify for derecognition |

These classifications do not represent a change from IAS 39.

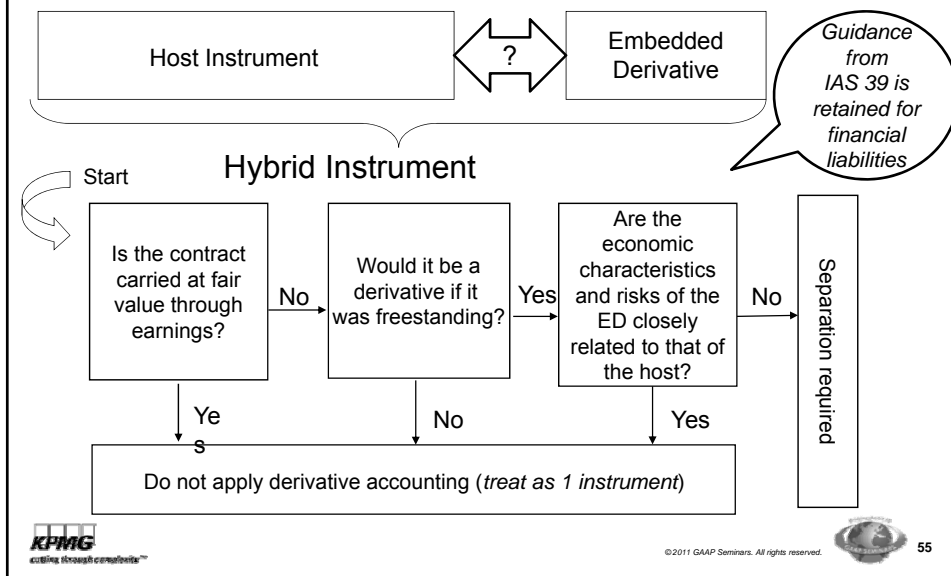


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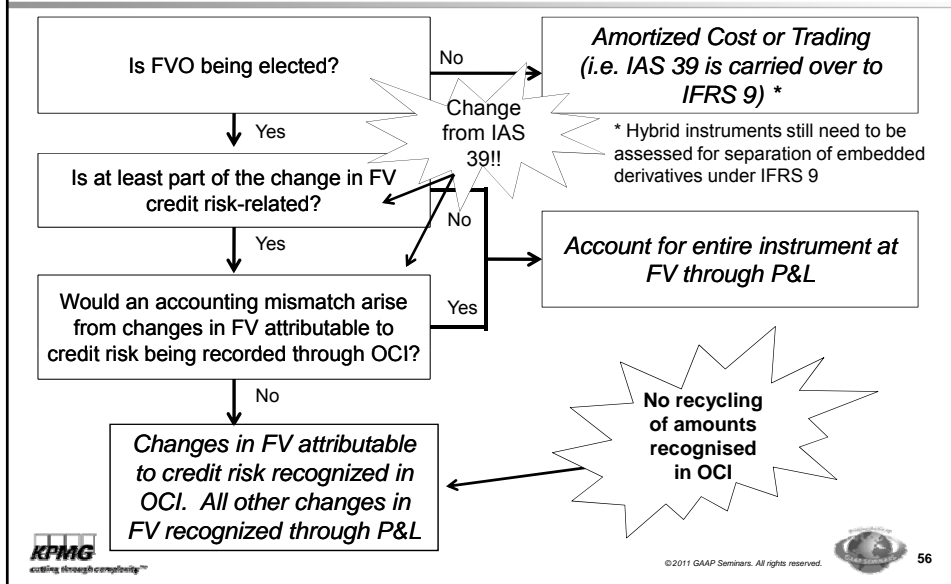


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Hybrid Instruments (with a financial liability host)



IFRS 9: Measurement of Financial Liabilities



Class Discussion: Calculating Changes in Credit Risk

- Upon initial application of IFRS 9, Hungry Haggis elected the fair value option for certain of its liabilities. The CEO, Georgie Porgie, has since found out that not all of the fair value movements can go through the P&L! It was enough to make him cry!
- Georgie looked it up, and it says the “amount of change in the fair value of the liability that is attributable to changes in the credit risk of that liability shall be presented in OCI”.
- Georgie has gathered the following information, and has asked for help in calculating “the change in fair value attributable to changes in credit risk”.

Beginning of period: FV = \$50, benchmark interest rate = 2.5%
 End of period: FV = \$53, benchmark interest rate = 2.25%
 IRR of liability beginning of period = 7%, PVCF of liability at end of period = \$52

How would you go about calculating the amount to be presented in OCI?



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IFRS 9: Effective Date and Transition

General Transition Rules

1. Effective for years beginning on or after 1 January ~~2013~~
2. Earlier application is permitted
 - EU has not yet adopted this IFRS!

ED 2011/3
proposes
a change
to 2015!

“It has been decided that more time should be taken to consider the output from the IASB project to improve accounting for financial instruments.” (EFRAG website)

3. Retrospective application is required in accordance with IAS 8
 - Adjust comparative amounts disclosed
 - Adjust opening balance of equity for earliest period presented

As if had
always
applied
IFRS 9!

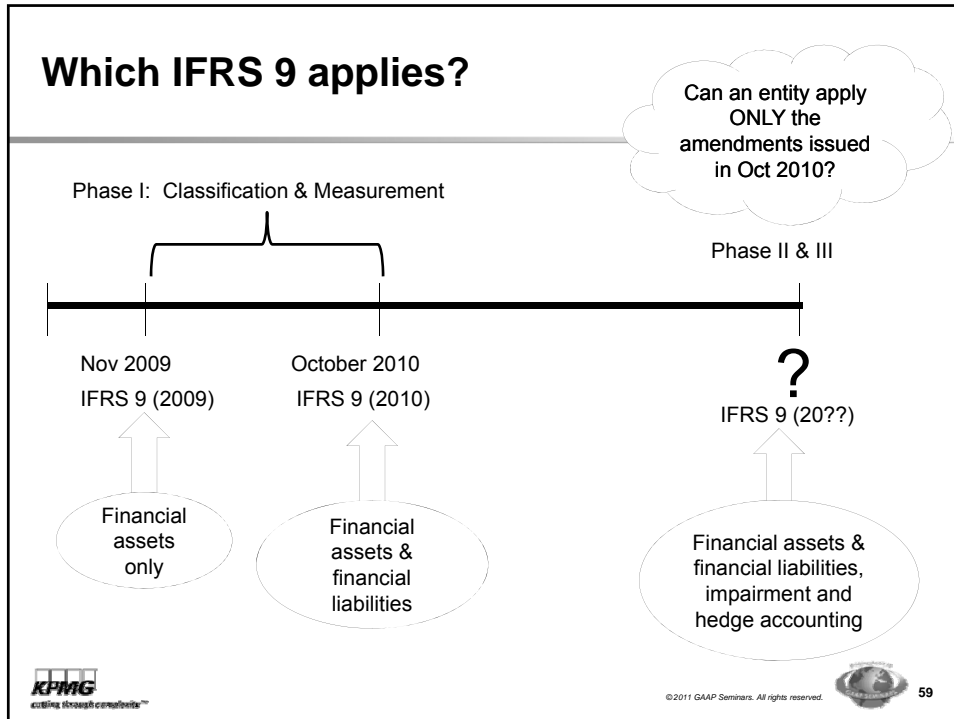


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Which IFRS 9 applies?



The Finishing Touches: Phase II and III

- Phase 2
 - November 2009 issued ED 2009/12 “Amortised Cost and Impairment”
 - Issued Supplementary Document (Joint) with revised impairment model in January 2011
 - Revised impairment model was scrapped by the Boards in May 2011, and is currently being re-deliberated.
- Phase 3
 - Hedge Accounting ED issued December 2010
 - Scope: Does NOT address “macro hedging” of open portfolios (of particular importance to financial institutions)

Impairment of Financial Assets: Latest Developments on ED's

IASB ED Impairment Model:

Impairment: expectations about credit losses *without a probability threshold* over the life of the instrument. Initial expected credit losses included in the effective interest calculation, resulting in losses being recognized as a reduction in interest income. Subsequent changes recognized as they occur.

Critics: Too little, too late and likely to be difficult to distinguish between initial estimates and subsequent changes in estimates for open portfolios

FASB ED Impairment Model:

Impairment: recognized when the entity does not expect to collect all contractual cash flows *without a probability threshold*. Impairment is based on information relating to past events and existing conditions (i.e. NOT future forecasts of economic conditions)

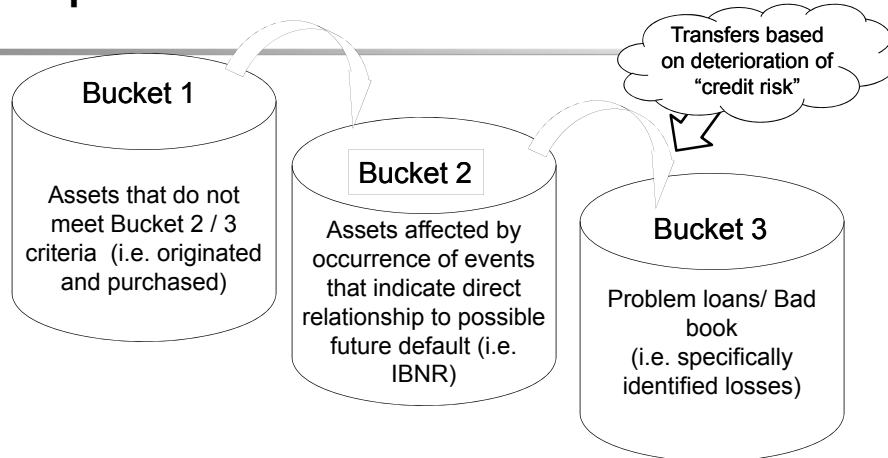
Critics: Too much, too soon & not a true "expected loss" model as future forecasts are not allowed.



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Impairment: Decisions to Date



Guiding Principle:

"To reflect the general pattern of deterioration of credit quality of financial assets" based on CRM systems.



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The Finishing Touches: Phase II and III

- Phase 2
 - November 2009 issued ED 2009/12 “Amortised Cost and Impairment”
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Fair Value



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IFRS 13: Fair Value Measurement

- **Defines fair value**

- The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date

This is an *exit-price* definition of fair value!

- **Establishes a framework for measuring fair value**

- Valuation techniques
- Inputs to valuation techniques
- Fair value hierarchy

- **Expands disclosures about fair value measurements**

- **Does not introduce new fair value measurements**

- **Substantially similar to U.S. GAAP**

Effective date: Prospectively for annual periods beginning on or after 1 January 2013 with earlier application permitted.



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Comparing Fair Value (Then and Now)

Definition of Fair Value (per older version of IAS 32)

Amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

Definition of Fair Value (per IFRS 13 *Fair Value Measurement*)

The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Is there a difference?

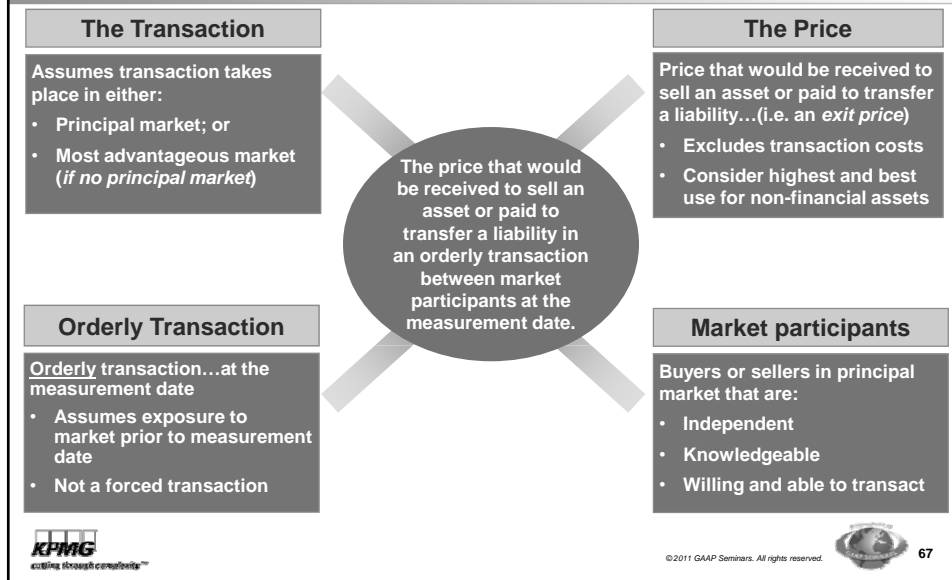


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Definition of Fair Value



Class Discussion: Orderly Transactions

Puppet Bank just received Federal bailout money and, not surprisingly, has suddenly become less critical of the government's policies. In addition to foregoing the company's annual retreat in Malaga and being put on a strict EUR 250,000 office remodeling budget, the government has "kindly suggested" that it unload some of its investments in the market within the next 6 months to raise some much needed capital. Puppet Bank owns a position of Marionette Co. bonds which it purchased at par (i.e. 100) for EUR 50 million. Puppet classifies the Marionette bonds as available-for-sale and currently has them on the books at 85 based on an internal pricing model which uses unobservable inputs (i.e. Level 3). Puppet Bank sold half of the position for EUR 12.5 million (at 50) after receiving three binding broker quotes, but refuses to write down the other half of the position, arguing that this transaction was "forced" and is not representative of fair value.

Does the situation described above represent a "forced" transaction? Why or why not?

Class Discussion: Market Participant Assumptions

Buck Bank holds several position in various start-up companies who recently went public. Under of the terms of the investment agreement with the start-ups, Buck Bank is restricted from trading these instruments until nine (9) months after the entity's initial public offering. After discussion with its auditors, Buck Bank understands that fair value for Level 1 financial instruments should be calculated as "P x Q" (price times quantity) and, given that these investments are now trading on an active market subsequent to their IPO, we have a Level 1 fair value measurement. However, given the restriction on the investments held, Buck Bank feels that this approach would not fairly represent the fair value of his investments.

Can Buck include a restriction "discount" when valuing its investments in restricted stock?



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Class Discussion: Active Market

Keaton Bank holds 1 million shares of Skippy, Inc. On 31 December the share are trading on the NASDAQ for USD 20 per share. Keaton Bank would like to include a liquidity discount of 10% to the fair value of these shares because of its unusually large holding in Skippy. Based on analysis performed by Keaton Bank, the average daily trading volume of Skippy is only 250,000 shares. When compared to its holding of nearly 4 times this amount, there is no way that an "exit price" of USD 20 could be attained for all 1 million shares of Skippy. Keaton Bank has determined that if it sold its entire holding it would only receive USD 18 per share (i.e. 10% discount is warranted).

Is it proper for Keaton to include a liquidity provision on its fair value measurement of Skippy?



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Active Markets and Adjustments to Level 1 Inputs

Active market

- A market in which transactions for the asset or liability take place with sufficient frequency and volume to provide pricing information on an ongoing basis

A quoted market price in an active market provides the most reliable evidence of fair value and shall be used without adjustment to measure fair value whenever available, except:

- When an entity utilizes an alternative pricing method as a practical expedient for a large number of similar (but not identical) assets or liabilities (e.g. matrix pricing)
- When a quoted market price in an active market does not represent fair value at the measurement date (e.g. significant events after market close but before measurement date)
- When measuring the fair value of a liability or an entity's own equity instrument using the quoted price for the identical item traded as an asset in an active market and that prices needs to be adjusted for certain factors (e.g. third party credit enhancements)

Use of a blockage factor is prohibited, even if a market's normal daily trading volume is not sufficient to absorb the quantity held and placing orders to sell the position in a single transaction might affect the quoted price



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Indicators of a Significant Decrease in Volume or Level of Activity

- There are few recent transactions
- Price quotations are not developed using current information
- Price quotations vary substantially either over time or among market-makers
- Indices that were previously highly correlated are demonstrably uncorrelated
- Significant increase in implied liquidity risk premiums, yields or performance indicators
- Wide bid-ask spread or a significant increase in the bid-ask spread
- Significant decline in or absence of new issues for the asset or liability
- Little information is publicly available



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Class Discussion: Determining the FV for Alternative Investments

Evenflo LLC owns an interest in the Jobe Fund, a private equity fund for patient investors. Each quarter Evenflo records the fair value of its interests based on the net asset value (NAV) provided to them by the fund. Recently, Evenflo has noted that other investors in the Jobe Fund have been selling their interests in the secondary market at a considerable discount (25%) from the most recently reported NAV. The reasons for the sale are not publicly known and information is very hard to come by, but it appears due to liquidity, capital and portfolio composition concerns. Recent market turmoil has led Evenflo to determine that these transactions are distressed. Therefore, Evenflo is going to ignore these market transactions, be patient and use the NAV provided by the fund.

Does NAV equal fair value in this case? Why might NAV not equal fair value? Is the approach taken by Evenflo proper?



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Practical Guidance Regarding the FV of Alternative Investments

- Appropriate “unit of account” is the interest in the fund itself
- Principal market is a hypothetical transaction in the secondary market
- Net asset value (NAV) can be used as a starting point, but it is not necessarily indicative of fair value (i.e. adjustments may be necessary)
- Valuation techniques consistent with income or market approaches
- Examples of inputs used to measure fair value include:
 - NAV
 - Transactions in principal-to-principal or brokered markets
 - Features of the alternative investments (e.g. restrictions on redemptions)
 - Expected future cash flows appropriately discounted
- External market transactions cannot be ignored

Use of the net asset value without adjustments is not always appropriate and IFRS 13 does not have a practical expedient for use of the NAV unlike U.S. GAAP!



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Fair Value of Non-Financial Assets: Highest and Best Use

- Use of the asset by market participants that would maximise the value
- Physically possible, legally permissible and financially feasible at the measurement date
- In-use premise – provides maximum value to market participants principally through its use in combination with other assets as a group
 - Fair value of the assets is determined based on the price that would be received in a current transaction to sell the asset assuming the asset would be used with other assets and that those assets would be available to market participants
- In-exchange premise – provides maximum value to market participants principally on a standalone basis
 - Fair value of the asset is determined based on the price that would be received in a current transaction to sell the asset standalone

Highest and best use is based on use of the asset by market participants, even if the entity intends to use the asset in a different manner!

Class Discussion: Highest and Best Use of a Tract of Land

An entity operates a factory on a parcel of land. As an industrial property, the value of the land is EUR 300,000 and the value of the factory is EUR 140,000. The highest and best use of land is to demolish the factory and build residential property, for which planning permission could be obtained at little cost. As a site for residential property, the fair value of the vacant site, after considering the cost of demolishing the factory and other conversion costs, is EUR 550,000.

What is the fair value of the land? What is the fair value of the factory?

Class Discussion: Measuring Liabilities at Fair Value

On 1 January, Wheezy Bank issues, at par, a EUR 2 million debt instrument which pays a fixed 10% interest over five years. The debt instrument is exchange-traded and is rated BBB by the rating agencies. Wheezy has elected to account for this instrument under the fair value option.

On 31 December, the instrument is trading as an asset in an active market and valued at 92.9 (i.e. 92.9% of par) after the payment of accrued interest.

How should Wheezy determine the fair value of its debt? Would your answer change if the debt security was not exchange-traded?



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Determining the Fair Value of Liabilities

- **Assumes liability is transferred to market participants (but not extinguished) at measurement date**
 - Assumes an ongoing obligation, not settlement of obligation
- **Consider non-performance risk of the reporting entity**
 - Includes the reporting entity's own credit risk
 - Effect of credit risk may differ depending on liability (e.g. obligation to deliver cash vs. goods/services)
 - Consider terms of any credit enhancements related to the liability, if any
- **If a quoted market price in an active market for the liability is not available, use one of the following approaches:**
 - Valuation technique that uses the quoted market price of an investment in the identical liability traded as an asset
 - Valuation technique that uses the quoted market price for similar liabilities or quoted market prices for investments in similar liabilities traded as assets
 - Another valuation technique that is consistent with the fair value principles within IFRS 13
- **Include adjustment for factors specific to the asset that do not apply to the fair value measurement of the liability**
- **Do not include a separate input or adjustment to reflect restrictions on ability to transfer**



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IFRS 13: Valuation Techniques

Market Approach: uses observable market prices and other relevant information derived from market transactions involving identical or comparable assets/liabilities

Income Approach: uses valuation techniques (based on market assumptions) to convert future benefits or costs usually in the form of cash flows, into a present value amount

Cost Approach: uses estimates of the cost to replace an asset's service capacity

Evaluate the merits of the techniques to decide which to apply or perhaps weigh the results of different valuation techniques!

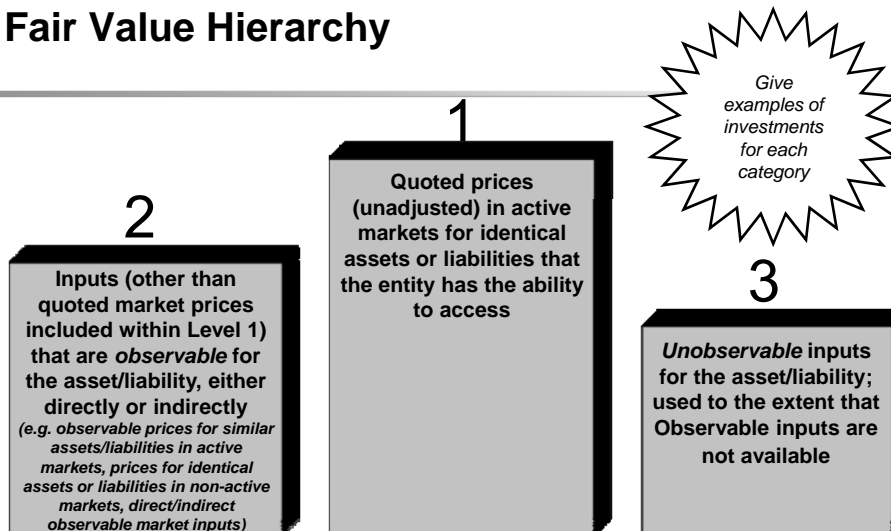


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Fair Value Hierarchy



The overall "fair value level" is dictated by the lowest level within the hierarchy of any significant input used in determining fair value.



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Class Discussion: Fair Value Hierarchy

Styx Bank holds the following assets and liabilities which it measures at fair value on a recurring basis:

- Plain-vanilla, LIBOR-based receive-fixed, pay-variable interest rate swap with Renegade Bank valued using an income approach
- Investment in Roboto, Inc., a non-public company valued using earning multiples from comparable companies, adjusting for specific factors related to Roboto
- Condo in the prestigious “Come Sail Away” neighbor in Biscayne Bay valued using market approach considering the price per square foot of recent condo sales
- Foreign-currency swap whereby Styx will swap USD 10 million with Lorelei Co. and receive EUR 13 million in thirty years

Which level in the hierarchy (i.e. Level 1, Level 2 or Level 3) would the following fair value measurements be classified?



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Required Disclosures ⁽¹⁾

| Required disclosure | Measured at FV in BS (Recurring) | Measured at FV in BS (Non-recurring) | Disclosed at FV in notes |
|---|----------------------------------|--------------------------------------|--------------------------|
| The fair value at the reporting date and its level in the fair value hierarchy | √ | √ | √ |
| The reason it is measured at fair value | | √ | |
| The amounts of transfers between Levels 1 and 2, the reasons for those transfers, and the entity's policy for determining when transfers between levels are deemed to have occurred | √ | | |
| For Levels 2 and 3 a description of the valuation technique(s) and inputs used | √ | √ | √ |
| For Level 2 and 3 fair value measurements for which there has been a change in valuation technique, disclose the change and reason(s) for making it | √ | √ | √ |



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Required Disclosures (2)

| Required disclosure | Measured at FV in BS (Recurring) | Measured at FV in BS (Non-recurring) | Disclosed at FV in notes |
|--|----------------------------------|--------------------------------------|--------------------------|
| If the highest and best use of a non-financial asset differs from its current use, disclose that fact and why the non-financial asset is being used in a manner that differs from its highest and best use | √ | √ | √ |
| Information sufficient to permit reconciliation between the disclosures of classes or assets and liabilities by fair value hierarchy and the line items presented in the statement of financial position | √ | √ | |
| If an entity makes an accounting policy decision to use the exception in paragraph 46 (i.e. offsetting), disclose that fact | √ | √ | |
| For a liability measured at fair value, disclose the existence of any credit enhancement and whether it is reflected in the fair value measurement of the liability | √ | √ | |



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Required Disclosures (3)

| Required disclosure – Level 3 measurements (only) | Measured at FV in BS (Recurring) | Measured at FV in BS (Non-recurring) | Disclosed at FV in notes |
|--|----------------------------------|--------------------------------------|--------------------------|
| Quantitative information about the significant unobservable inputs used in the fair value measurement (see Appendix A of IFRS 13 for an example of this quantitative disclosure requirement) | √ | √ | |
| A reconciliation of the opening and closing balances with separate disclosure of (i) amounts in profit or loss (and line item in which they are recognised), (ii) amounts in other comprehensive income, (iii) amounts of purchases, sales, issues and settlements (each type separately), and (iv) amounts of any transfers in or out of Level 3 (including the reasons for those transfers, and the entity's policy for determining when transfers between levels are deemed to have occurred) | √ | | |
| The amount of total gains or losses for the period included in profit or loss that is attributable to the change in unrealised gains or losses for those assets and liabilities held at the reporting date and the line item(s) in which the gains or losses are recognised | √ | | |
| Description of the valuations processes including, for example, how an entity decides its valuation policies and procedures and analyses changes in fair value from period to period | √ | √ | |



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Required Disclosures ⁽⁴⁾

| Required disclosure – Level 3 measurements (only) | Measured at FV in BS (Recurring) | Measured at FV in BS (Non-recurring) | Disclosed at FV in notes |
|---|----------------------------------|--------------------------------------|--------------------------|
| Narrative description of the sensitivity of fair value to changes in unobservable inputs if a change in those inputs to a different amount might result in a significantly higher or lower fair value measurement and a description of the interrelationships between unobservable inputs including how such interrelationship might magnify or mitigate the impact to fair value from changes in such inputs | √ | | |
| For financial assets and financial liabilities, when a change in one or more of the unobservable inputs to reflect reasonably possible alternative assumptions would change fair value significantly, an entity shall disclose that fact, the effect of those changes, and how the effect of the change is calculated | √ | | |



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Other Recently Issued Standards



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Elimination of Defined Benefit Plan Recognition Options

- **Varied recognition options** (IAS 19.92-93D)
Changes in obligation/assets resulting from experience different from that assumed, changes in assumptions, or plan amendments may be
 - **amortised** to profit or loss generally over the average remaining service period of active employees using either
 - the “corridor” method (i.e. amortising only amounts exceeding 10% of the greater of plan assets and defined benefit obligation), or
 - any faster amortisation method, or
 - **fully recognised in the year of occurrence**, either
 - in profit or loss, or
 - in other comprehensive income (not reclassified to profit or loss)

A new approach



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Revised IAS 19: New Approach to Recognition and Presentation

All changes in DBO and FV of plan assets in the period they occur

Statement of financial position

Profit or loss

Other comprehensive income

Funded status of defined benefit plans

+ Service costs
 +/- Finance costs

+/- Remeasurements

Revised IAS 19 issued in June 2011
Effective date: Annual periods beginning on or after 1 January 2013, earlier application permitted.



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Revised IAS 19: Highlights

Defined benefit plans

- Eliminate corridor method of smoothing recognition of actuarial gains and losses
- Net liability/asset shown on the statement of financial position (subject to asset ceiling)
- Recognise service cost and net finance income or expense in P&L
- Net finance income/expense measured by applying the discount rate used for determining the obligation to the net benefit liability or asset
- Recognise actuarial gains and losses in OCI; no reclassification to P&L
- Recognize unvested past service cost when the related plan amendment occurs
- Recognise settlement gain or loss when settlement occurs

Termination benefits

- Voluntary termination benefits only recognised when the employee accepts the offer

How will this affect entities' financial statements?



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Amendment to IAS 1: Presentation of Comprehensive Income

- Amendment issued in June 2011
- Retains the option to report a single continuous statement of comprehensive income or two separate but continuous statements
 - OCI items to be grouped into those that :
 - will *not* be reclassified subsequently to profit or loss; and
 - will be reclassified subsequently to profit or loss
- Tax impacts continue to be presented either:
 - Net of each separate component of OCI; or
 - As one amount of total expense or benefit within OCI
- Effective for annual periods beginning on or after 1 July 2012 (with retrospective application)



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Some Components of Other Comprehensive Income (OCI)

1. Unamortized actuarial gains/losses and past service costs related to defined benefit pension plans
2. Unrealized gains/losses on available-for-sale securities (IAS 39)
3. Unrealized gains/losses on equity instruments for which the fair value through OCI option has been selected (IFRS 9)
4. FX translation adjustments
5. PP&E revaluations
6. Effective portion of gains/losses on derivative instrument that qualifies as a cash flow hedge
7. Effective portion of gains/losses on hedging instrument in hedge of net investment in a foreign operation

Which items, if any, will never be reclassified subsequently to profit or loss?



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Presenting Income Tax Effects

There are currently two alternatives for presenting income tax effects on components of other comprehensive income:

1. Components of OCI are displayed *net of related tax effects* in the statement of comprehensive income, with details in the notes

2. Components of OCI are displayed *before related tax effects* with one amount of total tax expense or benefit

These two alternatives remain.



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IASB Project Plan and Recent Exposure Drafts



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IASB Work Plan – Completed Projects

Notice a trend re: an important date?

| Standard/Amendment | Issue date | Effective date |
|--|-------------------------|---|
| IFRS 9 <i>Financial Instruments</i> | Nov. 2009/ Oct. 2010 | Annual periods beginning on/after 1 January 2013* |
| Amendments to IFRS 7 <i>Disclosures - Transfers of Financial Assets</i> | Oct. 2010 | Annual periods beginning on/after 1 July 2011 |
| IFRS 10 <i>Consolidated Financial Statements</i> | May 2011 | Annual periods beginning on/after 1 January 2013 |
| IFRS 11 <i>Joint Arrangements</i> | May 2011 | Annual periods beginning on/after 1 January 2013 |
| IFRS 12 <i>Disclosure of Interest in Other Entities</i> | May 2011 | Annual periods beginning on/after 1 January 2013 |
| IFRS 13 <i>Fair Value Measurements</i> | May 2011 | Annual periods beginning on/after 1 January 2013 |
| Amendments to IAS 19 <i>Employee Benefits</i> | June 2011 | Annual periods beginning on/after 1 January 2013 |
| Amendments to IAS 1 <i>Presentation of Items of Other Comprehensive Income</i> | June 2011 | Annual periods beginning on/after 1 July 2012 |



* IASB considering further deferral of effective date until 2015

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IASB Work Plan – Active Projects

| Project | Q3 2011 | Q4 2011 | H1 2012 | H2 2012 | MoU | Joint |
|-----------------------------|---------|---------|---------|---------|-----|-------|
| FI – Deferral of IFRS 9 | ED | | | | | |
| FI - Impairment | | Re-ED | | | √ | |
| FI – Gen. Hedge Accounting | | | IFRS | | | √ |
| FI – Macro-Hedge Accounting | | ED | | | | |
| FI – BS Offsetting | | IFRS | | | √ | √ |
| Investment Companies | ED | | | | | √ |
| Leases | | | Re-ED | IFRS | √ | √ |
| Revenue Recognition | | Re-ED | | IFRS | √ | √ |
| Insurance Contracts | | | Re-ED | | | √ |

Many of these projects have experienced delays in 2011. However, it is still expected that these projects will be completed within the next year (or two)!



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Significant Proposed Change to Accounting for Leases



Leasing Exposure Draft issued in August 2010: Convergence project between the FASB and IASB

- **Comprehensive reconsideration of all IFRS and U.S. GAAP accounting guidance on leasing**

~~Finance lease~~

~~Operating lease~~

No more division into “finance” and “operating” leases. ALL leases would be recognized on lessee’s statement of financial position as “right-of-use” and “obligations to make lease payments”

No grandfathering of existing leases: All outstanding leases as of the date of initial application would be subject to the new models.



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NEWSFLASH: IASB Proposes Significant Improvements to Revenue Recognition

IAS 18 Principles

Significant risks and rewards transferred to the buyer

No continuing involvement/effective control

Amount of revenue can be reliably measured

Probable economic benefits

Costs can be reliably measured

Addresses multiple-element arrangements!

5-Step Approach:

1. Identify the contract(s) with a customer
 - While now explicit in standard, unlikely to result in many changes
2. Identify the separate performance obligations in the contract
3. Determine the transaction price
 - Estimate/probability-weighted
 - Include variable pricing and discounting (when significant)
4. Allocate the transaction price to the separate performance obligations
5. Recognize revenue when each performance obligation is satisfied
 - Based on transfer of *control*
 - Difference between goods & services



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Insurance ED: A Whole New World



No premium revenue (except certain short-duration contracts)

Explicit risk adjustment included in insurance liabilities

Discount rates, risk adjustments and cash flows updated each period

Incremental acquisition costs are netted against the insurance liability

Discount short-duration claim liabilities

Expected cash flows recorded, including expected policyholder behavior and participation



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