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Impairment of financial assets – where is it heading?

The IASB and FASB have both proposed changes to their impairment models for financial assets. Read about their proposed impairment models and certain alternative models proposed by constituents, as well as our views on this topic.

Multiple-element arrangements – how should revenue be recognised under IFRS?

Certain IFRS reporters have referred to the requirements of US GAAP to develop their accounting policies for multiple-element arrangements, given the lack of specific guidance under IFRS. We discuss whether the recent changes to the US GAAP guidance on multi-element arrangements have any impact on the accounting treatment of such arrangements under IFRS.

IFRIC 18 and utility companies – practical issues at every step

Utility companies face practical issues when adopting IFRIC 18 *Transfers of Cash from Customers*. Learn about these issues, and why IFRIC 18 may cause these companies to change their current accounting.

IFRS monthly update

Find out what's new this month from the IASB. We also highlight the projects currently being discussed by the IASB.

Resources

Look here for an up-to-date list of our recent publications, including *IASB and FASB focus on high priority projects*, which summarises the modified work plan of the IASB and FASB. Register for our upcoming webcast on the proposed revenue recognition model under IFRS and US GAAP.

We welcome your feedback on *IFRS outlook*. Please contact us at ifrs@ey.com. The next issue will be published in August 2010.

Ruth Picker
Global Leader of IFRS Services

Impairment of financial assets – where is it heading?



While the IASB has proposed a new model that recognises expected losses over the life of financial assets, the FASB is modifying its existing impairment model in an attempt to allow earlier recognition of credit losses.

The International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) (collectively, the Boards) have both published proposals for changes to their current impairment models. During the global financial crisis, these 'incurred loss' models were criticised for recognising credit losses too late.

While the IASB has proposed a new model that recognises expected losses over the life of financial assets, the FASB is modifying its existing impairment model in an attempt to allow earlier recognition of credit losses. In addition, constituents have proposed other alternative impairment models, some of which are variants of the IASB's proposed model.

In this article, we discuss both the IASB and FASB's proposed impairment models and certain alternative impairment models proposed by constituents, as well as our views on this topic.

The IASB's proposed impairment model

In its Exposure Draft (ED) *Amortised Cost and Impairment*, published in November 2009, the IASB proposed an expected cash flow model that would require an entity to determine expected credit losses on a financial asset measured at amortised cost when that asset is first recognised. These initial expectations of credit losses would be included in determining the effective interest rate (EIR).

Contractual interest revenue, less the initial expected credit losses, would be recognised in the income statement over the life of the instrument. Expected credit losses would be reassessed in each period and the effect of any change in expectations would be recognised immediately, as a 'catch-up adjustment' to the income statement, so as to maintain a constant EIR.

Refer to Supplement to *IFRS outlook* issue 61: *New proposals for financial instruments at amortised cost* for a summary of the ED and the impact it is likely to have on businesses.

The FASB's proposals

The FASB's proposals differ from those of the IASB in a number of ways. In its ED on *Financial Instruments*, published in May 2010, the FASB proposed to measure most financial assets at fair value, with changes recognised either through net income or other comprehensive income (OCI) (i.e., in equity), and would require an entity to determine if credit losses exist for financial assets whose fair value changes are recognised in OCI, for short-term receivables measured at amortised cost and for certain other assets. An entity would need to recognise credit losses when it does not expect to collect all contractual amounts due (for originated financial assets) and all amounts originally expected to be collected upon acquisition (for purchased financial assets). The entity would consider all available information

During the global financial crisis, these 'incurred loss' models were criticised for recognising credit losses too late.

relating to past events and existing conditions and their implications on the collectability of cash flows. The entity would not apply a probability threshold regarding the occurrence of possible outcomes in determining whether a credit loss exists, i.e., it would not wait until a credit loss is probable to recognise credit impairment. Interest income would subsequently be recognised by multiplying the amortised cost less cumulative credit impairment by the EIR.

Financial assets would be evaluated for impairment either individually or on a collective (or pool) basis (for pools of assets which share similar risk characteristics). However, if a financial asset is evaluated on an individual basis and it is determined that no credit impairment exists, an entity is required to determine whether assessing the financial asset on a collective basis would give rise to impairment. If historical information and existing conditions indicate that the reporting entity does not expect to collect contractual amounts due (for originated financial assets) or amounts initially expected to be collected (for purchased financial assets) over the lives of the financial assets in the pool (e.g., the pool of financial assets with similar risk characteristics has a history of credit losses), an impairment loss would be recognised. This could result in the recognition of credit impairment for the full amount of the losses expected over the life of the financial assets in the pool in the reporting period in which the assets are originated.

European Banking Federation's alternative impairment model

The European Banking Federation (EBF), an organisation comprising European banks, has proposed a variation on the IASB's expected cash flow model. This builds on the principle in the IASB ED of deferring income to reflect anticipated credit losses, with three major differences:

- i) It 'decouples' the deferral of income from the calculation of interest, so that the adjustments to defer interest income are calculated separately from 'gross' interest income. The total expected losses would be allocated 'systematically' to profit or loss, e.g., on a straight-line basis over the life of the pool of financial assets, to build up an allowance.
- ii) The effect of any changes in estimates of future losses would be spread over the remaining lives of the financial assets by increasing or decreasing the periodic impairment charge, rather than recording it entirely in the reporting period in which the change occurs. This calculation would be for an 'open portfolio' of assets, to or from which new assets are added and old ones removed as they mature, without the need to track expected cash flow assumptions by vintage (year of origination and maturity). This is in contrast to the 'closed portfolios' of assets, grouped by vintage and risk characteristics, that are operationally required to calculate the catch-up adjustments under the IASB ED.
- iii) When actual losses are incurred, they are charged against the established impairment allowance. If incurred losses exceed the amount of the allowance so far established, the excess would be recorded in the income statement. This incurred loss overlay means that entities would need to operate in parallel both an expected loss model and an incurred loss model. Although the systems and processes to calculate incurred losses are already established, retention of an incurred loss component to the approach would require further debate as to how this would in practice be determined, including whether it should include an estimate for losses that have probably been incurred but are not yet evident and, if so, how this should be calculated.

See Table 1 for the main features of the IASB, EBF and FASB proposed impairment models.

Impairment of financial assets – where is it heading? *continued*

Table 1: Main features of the IASB, EBF and FASB proposed impairment models

	IASB	EBF	FASB
Scope	Financial assets measured at amortised cost	Financial assets measured at amortised cost	Instruments measured at fair value through other comprehensive income (FV-OCI), short-term receivables measured at amortised cost and certain other assets
Principle	Determine expected credit losses on financial assets and defer a portion of interest income to account for such credit losses from inception, as part of EIR	Determine expected credit losses at the portfolio level and build up an allowance by allocating the expected losses over the average life of the portfolio (linearly or by other systematic allocation)	Recognise an impairment loss for all contractual amounts due for originated assets (or amounts originally expected for purchased financial assets) that the entity does not expect to collect, based on an assessment at the end of each reporting period
Consideration of future events	Expectations related to future events are included in the assessment of expected losses	Historical loss experience provides the basis for expected losses, but are adjusted, where necessary, to reflect the conditions that exist at the reporting date	Only historical data, adjusted for past events and current conditions, are used to determine the amounts not expected to be collected
Recognition of impairment loss	Credit losses are allocated over the life of financial assets based on the effective interest method (or practical expedient)	Credit losses are allocated over the life of financial assets based on straight-line or other systematic methods; if incurred losses exceed the existing impairment allowance, the excess is recorded in the income statement	Credit losses are recognised in the reporting period when it is determined that all contractual amounts due for originated assets (or amounts originally expected for purchased financial assets) will not be collected. For financial assets assessed on a collective basis (including those assets that are not individually impaired), this will normally result in the recognition of a credit impairment in the period financial assets are originated
Changes in estimates of future collections	Recognised immediately in the income statement as 'catch-up adjustments'	Recognised prospectively as adjustments to subsequent profit or loss over the residual life of financial assets	Recognised immediately in the income statement in the period the change occurs
Application to open portfolios	Difficult to apply the model to open portfolios as original loss assumptions, EIR and vintages of assets are required to be tracked to determine catch-up adjustments	Assess expected losses for open portfolios of assets with similar risk characteristics, instead of closed portfolios, as there is no need to track the original loss assumptions of assets by vintage to determine the catch-up adjustments as under the IASB ED	Possible to assess losses for open portfolios of assets with similar risk characteristics. (The FASB's proposed model does not require the calculation of the catch-up adjustments as under the IASB ED. Therefore, there is no need to track the original loss assumptions of assets by vintage)
Possible impact on profit or loss	Deferral of a portion of interest revenue, with possible volatility in profit or loss due to catch-up adjustments when estimates of amount or timing of future collections change	Allocation of expected losses over the average life of a portfolio of assets; less volatility in the income statement than the IASB's proposed impairment model as changes in estimates of future collections are adjusted prospectively	Recognition of expected life-time losses for a pool of loans or other financial assets in the reporting period the assets are originated or purchased
Operational complexity	Complex (unless practical expedients can simplify the application)	Potentially more complex than the IASB's proposal due to parallel application of an expected loss model and an incurred loss model	Less complex than the IASB's proposed model



Expert Advisory Panel

The Expert Advisory Panel (EAP), set up to advise the Boards on how practical challenges to their impairment proposals might be addressed, has discussed possible practical expedients and potential solutions to many of the challenges presented by the IASB model, as well as alternative impairment models, including the EBF model.

A simplified version of the expected cash flow model, set out below, has been discussed and proposed by a number of EAP members:

- i) Similar to the EBF model, the approach decouples the recognition of income and impairment. The total expected losses for an open portfolio of financial assets (comprising assets with similar risk characteristics) would be estimated at initial recognition and the losses allocated over the average life of the portfolio, so as to build up an allowance by deferring income.
- ii) When a financial asset in the portfolio is known to be impaired, the asset would be transferred out of the portfolio of unimpaired assets and the full expected loss would be recorded in the income statement.

The expected losses for the remaining portfolio of unimpaired assets would be re-estimated at each reporting date, to reflect changing experience and circumstances. The allowance would be adjusted to reflect the proportion of the average life of the portfolio that has so far elapsed, as if the revised expected losses had always been assumed in the deferral of income. So, for instance, if on average, two years have elapsed on a portfolio with an average expected life of five years, the cumulative allowance should represent two-fifths of the revised expected losses.

How we see it

While we appreciate the technical merit of the IASB ED's principle of deferring income to reflect anticipated credit losses, we believe that the cost of implementation and the very considerable operational difficulties of the proposed expected cash flow model outweigh the benefits.

Underlying the approach taken by the IASB ED would appear to be two (connected) objectives: i) to determine the allocation of interest income and expense to reporting periods; and ii) to measure impairment of financial assets recorded at amortised cost. It would be clearer if these were set out as two separate objectives. To do so

leads more logically not only to the proposed approach, but also to other possible approaches which decouple income recognition and impairment and address them separately. In particular, we do not believe the immediate catch-up adjustments required by the IASB ED are consistent with the principle in the ED *Revenue from Contracts with Customers* that was recently jointly issued by the Boards. This principle allocates a change in transaction price to the entire performance obligation, which is only discharged over the life of a financial asset. Consequently, if an expected cash flow approach were to be adopted, we believe that changes in the expectations of cash flows on a financial asset should be allocated to income in proportion to the amount of the performance obligation that has been discharged (similar to the alternative model proposed by some members of the EAP, described above).

It is possible that further development and simplification of the proposed IASB approach may address our concerns about the cost of implementation and the operational difficulties. A possible solution is the EAP proposal discussed above, further simplified by using historical loss rates as the 'default' assumption, adjusted to reflect past events and current conditions (including consensus views on the near term development of the economy). We suggest that there should also be disclosure of the effect of making such adjustments to historical loss rates.

Meanwhile, we are concerned that the approach to accounting for impairment of financial assets set out in the FASB ED differs significantly from that in the IASB ED. We would much prefer the two impairment methods to be sufficiently similar to permit an easier comparison of the income statements of entities reporting under the two different regimes. On the broader topic of financial instruments, we continue to support the mixed measurement model set out in IFRS 9 *Financial Instruments* and urge the Boards to continue their convergence efforts.

The comment period for the IASB ED ended on 30 June 2010. The IASB expects to publish a new standard in the second quarter of 2011.

The comment period for the FASB ED on financial instruments ends on 30 September 2010. The FASB expects to publish a new standard on financial instruments in the second quarter of 2011.

Multiple-element arrangements – how should revenue be recognised under IFRS?

Many businesses offer their customers multiple products or services under a single contractual arrangement. Although IAS 18 *Revenue* acknowledges that the revenue recognition criteria may have to be applied to separate components of a single transaction, IFRS lacks specific guidance on how to account for these multiple-element arrangements. As a result, entities have developed their own accounting policies, in some cases referring to the requirements of US GAAP. This article considers the requirements of IFRS and whether recent changes to the US GAAP guidance for multiple-element arrangements are consistent with the principles of IFRS.

IFRS guidance

Current IFRS provides little revenue recognition guidance for multiple-element arrangements. IAS 18 only indicates that, in certain circumstances, it is necessary to apply the recognition criteria to the separately identifiable components of a single transaction in order to reflect the substance of the transaction. However, it does not provide any further guidance regarding under what circumstances transactions should be separated, or where separated, how the revenue should be allocated to the different components.

In the absence of further guidance, IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires management to use judgment to develop an appropriate accounting policy. In making that judgment, entities should refer to the requirements of IFRS dealing with similar issues and the definitions contained within the *Framework for the Preparation and Presentation of Financial Statements*.

In June 2007, the IFRS Interpretations Committee issued IFRIC 13 *Customer Loyalty Programmes* which requires award credits to be treated as a separate component of the initial sales transaction with the customer. IFRIC 13 does not prescribe a method for allocating the consideration between the award credit and the other components of the transaction. However, the Basis for Conclusion states that the amount allocated to the award credits may be either equal to their fair value (the residual method), or may be a proportion of the total consideration based on the fair value of the award credits relative to the fair value of other components (the relative fair value method).

IAS 8 permits entities to consider the most recent pronouncements of other standard-setting bodies, provided that they do not conflict with IFRS. Therefore many entities have looked to US GAAP for more prescriptive guidance on multiple-element arrangements. However, recent changes to the US GAAP guidance require a reassessment of whether the US GAAP treatment is still consistent with IFRS.

Looking to US GAAP – a summary of recent changes

In September 2009, the FASB ratified Emerging Issues Task Force (EITF) 08-01 *Revenue Arrangements with Multiple Deliverables*. EITF 08-01 amends the existing guidance on multiple-element revenue arrangements currently included in Accounting Standards Codification (ASC) 605-25 *Revenue Recognition – Multiple-Element Arrangements*.

The revised guidance provides for two significant changes. The first change relates to the determination of when the individual deliverables included in a multiple-element arrangement may be treated as separate units of accounting. The second change modifies the manner in which the transaction consideration is allocated across the separately identified units of accounting. Together, these changes are likely to result in earlier recognition of revenue for multiple-element arrangements than under the previous guidance. Table 2 compares the guidance before and after the changes introduced by EITF 08-01.



Table 2 – Summary of changes introduced by EITF 08-01

Determination of separate units of accounting	
Current guidance	Changes introduced by EITF 08-01
1. The delivered item(s) has stand-alone value	1. Criterion is unchanged
2. There is objective and reliable evidence of the fair value of the undelivered item(s)	No longer required
3. When a general right of return exists for the delivered item, the delivery or performance of the undelivered item is probable and is substantially in the control of the seller	2. Criterion is unchanged
Allocation of arrangement consideration to separate units of accounting	
1. Allocation to all deliverables based on fair value when objective and reliable evidence of fair values exist for all units of accounting (relative fair value method)	1. Allocation to all deliverables based on their relative selling prices (relative selling price method)
2. Residual method is used when objective and reliable evidence of fair value exists for the undelivered item (residual amount is assigned to the delivered item)	Residual method is not permitted
3. Reverse residual method (residual assigned to undelivered item) is not permitted	Reverse residual method is not permitted
Measurement hierarchy for fair value/selling price	
1. Vendor-specific objective evidence (VSOE) of fair value – the price charged for a deliverable that is sold separately or if not yet being sold separately, the price established by management and not likely to change prior to the launch of the new product or service	1. Vendor-specific objective evidence (VSOE) of selling price – change in term only (i.e., replace fair value with selling prices; determination of VSOE has not changed)
2. Third party evidence (TPE) of fair value – for example, the vendor or competitor prices of interchangeable products or services sold in to similar customers	2. Third party evidence (TPE) of selling price – change in term only (i.e., replace fair value with selling prices; determination of TPE has not changed)
	3. Best estimate of selling price – the price that the seller would use if the deliverable were sold by the vendor on a stand-alone basis considering market conditions as well as entity-specific factors

Accounting for multiple-element revenue arrangements

ASC 605-25 established three criteria, all of which had to be met, in order for a deliverable to be accounted for separately from the other deliverables in a multiple-element arrangement. One of the criteria was that there was “objective and reliable evidence of the fair value of the undelivered items”. In practice, this criterion was frequently difficult to meet, i.e., the absence of objective and reliable evidence of fair value was a common reason why entities were unable to

separate deliverables in an arrangement under US GAAP. The lack of separability resulted in the bundling of deliverables for accounting purposes and, hence, the deferral of revenue until the last deliverable was satisfied. Many entities believe that this did not reflect the underlying economics of many transactions.

EITF 08-01 revises the US GAAP revenue recognition guidance, in part, by eliminating the requirement that “objective and reliable evidence” of the fair value exists for the undelivered items in order for a delivered item to be treated as a separate unit of account.

Multiple-element arrangements – how should revenue be recognised under IFRS? *continued*

Allocation of transaction consideration

EITF 08-01 also modifies the methodology used to allocate transaction consideration to each of the identified units of accounting. Under the previous guidance, if objective and reliable evidence of fair value existed for all of the units of accounting identified, allocation of the transaction consideration was based on the relative fair values of all the elements of the transaction. Alternatively, when evidence of fair value existed only for the undelivered items (but not for the delivered items), the arrangement consideration was allocated using a residual method. Under the residual method, transaction consideration is allocated to the undelivered items based on their fair value. The remainder of the transaction consideration – the residual – is allocated to the delivered items. In many instances, entities were unable to demonstrate that evidence of fair value existed for the delivered items within an arrangement. Hence, the residual method was frequently used by entities providing multiple deliverables within an arrangement.

EITF 08-01 now requires arrangement consideration to be allocated to all deliverables based on their relative-selling price (i.e., the relative-selling price method). Under the relative-selling-price method, the selling price for each deliverable is determined using vendor-specific objective evidence of selling price, if it exists. Otherwise, the selling price is determined based on third-party evidence of selling price. If neither vendor-specific objective evidence nor third-party evidence of the selling price exists, the vendor uses its best estimate of the selling price for the deliverable.

Does this change the accounting treatment under IFRS?

The residual method referred to under IFRIC 13 is now prohibited under US GAAP, which has raised the question as to whether this method may continue to be used under IFRS. To answer this question, we must first consider the context in which it is referred to under IFRS. IFRIC 13 was issued to address the diversity in practice in the accounting for award credits as some companies were accounting for them as a component of the sales transaction whereas others were accounting for the cost of supplying the future good or service. While IFRIC 13 refers to the residual method for management's consideration in the accounting for loyalty programmes, it does not change the overall principle of IAS 18, that is, revenue should be recognised at the fair value of the consideration received or receivable for each component of the transaction.

So while IFRS reporters can look to IFRIC 13 to support the continued use of the residual method for transactions that do not involve loyalty points, the overall principle of IAS 18 will always need to be considered when reviewing the resulting allocation. As the residual method allows entities to recognise revenue in situations where the fair value does not exist for all components of the transaction, it may not always result in revenue recognition that is consistent with the overall principle of IAS 18. In addition, the difference between the residual method and the relative-selling price method is often immaterial on individual transactions involving award credits. However, applying the residual method to a transaction made up of significant elements, depending on the specific pricing, may yield a materially different allocation when compared to the relative-selling price method. Consequently, we believe that the relative-selling price method now required under US GAAP is more consistent with the overall principle of IAS 18, and should be the preferred method for allocating transaction consideration under IFRS.

Conclusion

For entities reporting under IFRS, the principles of IAS 18 must always be applied. Entities may continue to look to US guidance as the changes introduced are considered to be consistent with the overall principle of IAS 18.

US GAAP continues to provide prescriptive guidance in other areas where IFRS is silent, such as how to treat contingent consideration. For such issues, IFRS reporters can continue to look to this guidance provided that the IAS 8 criteria are met. In addition, the accompanying article discusses how utility entities should apply the requirements of IFRIC 18 *Transfers of Assets from Customers* and whether the US GAAP definition of 'stand-alone value' can be applied under IFRS.

The issues highlighted in this article are considered in the Exposure Draft *Revenue from Contracts with Customers*, which is a joint ED issued by the IASB and FASB on 24 June 2010. See the IFRS monthly update section of this publication.

IFRIC 18 and utility companies – practical issues at every step

While the requirements of IFRIC 18 *Transfers of Assets from Customers* can be summarised in a few simple steps, its adoption by companies within the utilities industry (utilities) is proving to be anything but simple. At each step of the process, utilities are faced with practical issues – primarily related to the conflict between IFRIC 18 and their rate setting process. This article explores these practical issues, and why IFRIC 18 may cause utilities to change their current accounting.

Background

Transactions in which a utility receives an item (or cash to acquire items) of property, plant and equipment from customers are routine in the industry. In the absence of specific guidance on such transactions under IFRS, a variety of accounting treatments emerged in practice. In many cases, the utility selected accounting policies that aligned with how the regulator required it to account for such transactions when establishing rates. Many regulatory regimes focus on matching revenues and expenses, which is replicated in the utility's external financial statements.

The requirements of IFRIC 18 are summarised in the flow chart in table 3. IFRIC 18 focuses on determining whether the contributed item meets the definition of an asset and the utility's obligations that arise from the contribution. IFRIC 18 does not address the accounting for the effects of rate regulation. The IASB attempted to address the effects of rate-regulated activities in an exposure draft, but the status of this project remains uncertain. As a result, the matching of revenues and expenses that utilities experience under regulatory reporting may not be available under IFRS where the priority is asset and liability recognition rather than matching of revenues and expenses. Nonetheless, there is tension between the requirements of IFRIC 18 and a utility's regulatory regime. Below, we discuss the common practical issues and how we believe utilities could address them.

Are all upfront payments within the scope of IFRIC 18?

Regulators will usually establish, for different categories of customers, which upfront connection fees can be charged as well as the rate for the ongoing supply. These upfront fees are often referred to as connection or backbone charges. In some instances, the amount charged to the customer covers only a portion of the actual costs incurred to connect that customer to the network. In other situations, the payment received is to support general maintenance of the network, for example, where a property is already connected, but the regulator permits an upfront charge when the property changes ownership.

Paragraph 6 of IFRIC 18 addresses cash contributions and states that IFRIC 18 "applies to agreements in which an entity receives cash from a customer when that amount of cash must be used only to construct or acquire an item of property, plant, and equipment and the entity must then use the item of property, plant and equipment either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services, or to do both."

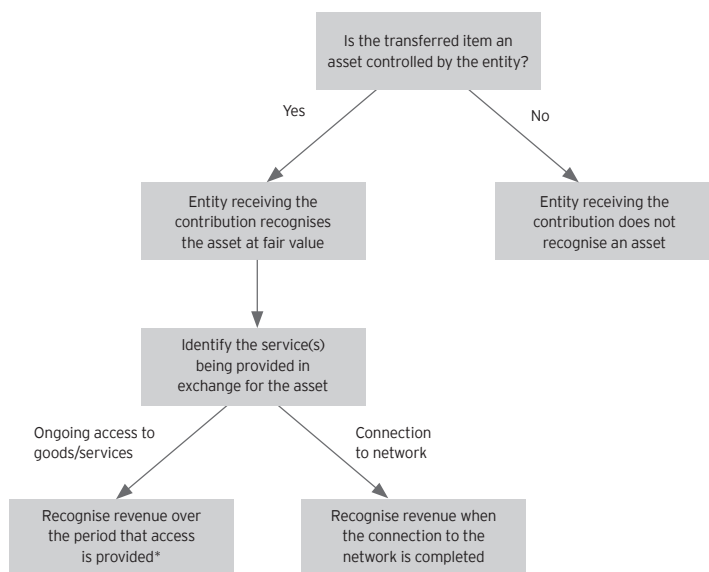
While these upfront fees are often labelled as connection or backbone charges, we believe that in order for these payments to fall within the scope of IFRIC 18, at least some portion of the fee must be directly used to purchase or construct an item of property, plant and equipment that is then used to connect the customer to the network and provide ongoing goods or services.

Hence, charges allowed by the regulator that are not directly related to the acquisition or construction of incremental property, plant and equipment do not fall within the scope of IFRIC 18. These payments should be accounted for under the requirements of IAS 18 *Revenue*. However, many of the practical issues discussed below will also be relevant to the accounting treatment of these amounts under IAS 18.

IFRIC 18 and utility companies – practical issues at every step *continued*

Table 3 - IFRIC 18 flowchart

IFRIC 18 is applicable to transfers received on or after 1 July 2009.



*If the agreement is silent, this is no longer than the life of the related asset.

Is the asset definition met?

Once an agreement is determined to be within the scope of IFRIC 18, the next step is to determine if the contributed item meets the definition of an asset for the recipient. The *Framework for the Preparation and Presentation of Financial Statements* defines an asset as:

“A resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity.”

In determining whether the asset definition is met, two key aspects must be considered: does the entity control the asset and will future economic benefits flow to the entity?

Control

Control is not determined solely by the transfer of legal ownership, and will require a careful assessment of the facts and circumstances. Factors that would indicate that the transferred asset is controlled by the utility are the utility’s ability to:

- ▶ Exchange the asset for other assets to deliver the same service
- ▶ Employ the asset to produce other goods or services or settle a liability
- ▶ Charge a price for others to use it
- ▶ Decide how the transferred asset is operated and maintained when it is replaced

Future economic benefits

The second element is determining if future economic benefits will flow to the entity. Utilities regulated under a ‘cost of service’ mechanism are finding a conflict between how the regulator accounts for items contributed or funded by customers and the requirements of IFRIC 18. The aim of a ‘cost of service’ model is to establish rates that earn the entity a specified rate of return (or a return within a certain range), and rates are often set using formulas involving an entity’s asset base. Most regulators exclude assets or portions of assets that are contributed or funded by customer contributions.

This raises the issue as to whether an asset’s exclusion from the rate-base calculation for establishing tariffs is an indicator that the asset definition has not been met. Arguments supporting this view are that these assets are not associated with any “future economic benefits that will flow to the entity”.

In our view, the regulator’s decision to exclude items of property, plant and equipment from the rate setting process is not an indicator that the asset definition has not been met. Paragraph 53 of the *Framework* states that “the future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and cash equivalents to the entity.” While contributed assets may not increase the overall level of returns permitted by the regulator, the utility does have the benefit of having an additional customer as a result of the connection. As these customers consume the ongoing service of the utility, they contribute directly to the revenues of the utility. Also, in some markets, only a portion of the utility’s business is regulated, and these additional customers may potentially contribute to revenues in unregulated portions of the utility’s business. Finally, an entity’s ability to sell the asset is an indication that future economic benefits exists.



Fair value of the asset at initial recognition

For assets that the utility has purchased or constructed using cash contributions from the customer, the initial recognition is clear – they should be recognised at cost in accordance with IAS 16.

For contributed items controlled by the entity, IFRIC 18 requires the item of property, plant and equipment to be measured at fair value, which is defined in IAS 16 as “the amount for which an asset could be exchanged between knowledgeable, willing parties in an arm’s length transaction.” In most cases, the utility’s replacement cost will be the starting point for the determination of fair value.

Impairment considerations

Some argue that assets excluded from the rate setting process are impaired upon initial recognition. However, given these assets are used to service the aggregate customer base and do not generate cash flows on their own, paragraph 22 of IAS 36 *Impairment of Assets* would require them to be tested as part of the respective cash generating unit, rather than individually. Paragraph 22 states:

“Recoverable amount is determined for an individual asset, unless the asset does not generate cash flows that are largely independent of those from other assets or groups of assets. If this is the case, recoverable amount is determined for the cash-generating unit to which the asset belongs ...”

By recognising for financial reporting purposes assets at fair value in excess of the assets included for rate setting purposes, the risk of the cash generating unit being impaired is increased. While it is impractical to perform an impairment test for each customer contribution, utility entities may need to revisit the frequency with which they perform these impairment tests.

What separately identifiable services are provided in exchange for the asset?

Table 4 summarises the features identified in IFRIC 18 that indicate whether the service is a connection to a network or to provide ongoing access to a supply of goods or services, or a combination of both.

Table 4 – Features indicating type of service provided

Connection to a network	Ongoing access to a supply of goods/services
<ul style="list-style-type: none"> ▶ Connection is delivered to the customer and represents stand-alone value for that customer 	<ul style="list-style-type: none"> ▶ Goods or services received via the connection are charged at a price lower than that paid by other customers who have not contributed an asset
<ul style="list-style-type: none"> ▶ Fair value can be reliably measured 	
<ul style="list-style-type: none"> ▶ Goods or services received via the connection are charged at the same price as other customers who have not contributed an asset 	

IFRIC 18 and utility companies – practical issues at every step *continued*

Stand alone value to that customer

The first indicator that the asset is received in exchange for a connection to the network is that the connection has stand alone value to the customer. However, IFRIC 18 does not provide a definition of stand alone value. Using the hierarchy within IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*, entities could look to US GAAP for a definition of stand alone value – “if they are sold separately by any vendor or the customer could resell the delivered item on a standalone basis” (*Accounting Standard Codification 605-25 Revenue: Multiple Element Arrangements*). However, IFRS reporters are not necessarily restricted to the US GAAP definition of stand alone value, and may look to other sources of information.

Other factors that could be considered in determining if the connection has stand alone value are:

- ▶ **Does the customer have a choice with respect to the service provider?** A lack of choice in providers is an indicator that the connection does not have stand alone value.
- ▶ **If the customer does have the ability to choose the service provider, does the connection allow a future purchaser of the property to avoid connection charges with the new provider (i.e. a connection enhances the value of a property)?**
A connection that increases a property's value relative to a property that is not connected to the network indicates that the connection has standalone value.

Fair value can be measured reliably

The second indicator is that the fair value of the connection service can be measured reliably. Determining the fair value of any upfront connection in accordance with IAS 18 may not always be straightforward – particularly when the connection is not sold separately. The accompanying article discusses estimation methods permitted under US GAAP that a utility may look to in determining the fair value. The fair value of the total consideration is then allocated to the different deliverables.

Ongoing prices

The third indicator states that when all customers pay the same rate for the ongoing good or service, this is an indicator that the asset has been contributed in exchange for the connection, and not the ongoing supply of the utility. That is, the obligation to provide the ongoing good or service arises from the utility's operating licence as opposed to the agreement relating to the transferred item or cash contribution. However, the existence of rate regulation makes it harder to interpret this indicator. Prices established in a free market

can be assumed to approximate a measure of the fair value of the ongoing service. Accordingly, it would be clear that if that price is the same for all customers irrespective of whether they contributed to the cost of the utility's assets, there is no ongoing benefit to those customers that made a contribution. However, where the price charged to customers is regulated, it does not follow that that price is a true measure of the fair value of the ongoing service obligation. In these circumstances the ongoing prices indicator can be inconclusive.

Balancing the indicators

IFRIC 18 does not attribute a weighting or a priority to any of these features, and as a result, utility entities may find indicators that point to different directions. For example, many utilities have a legal obligation to provide ongoing services to all customers, indicating that the asset has been contributed in exchange for the connection, but the connection service may not have standalone value to the customer, which implies the opposite. In our opinion, no individual indicator is definitive and, as such, entities must consider all of the indicators, facts and circumstances. Since the Interpretation does not specify any hierarchy for evaluating the indicators, an entity can exercise its own judgment in reaching its balance of evidence conclusion.

How should cash payments be presented in the statement of cash flows?

Prior to the issuance of IFRIC 18, many utilities presented cash contributions from customers in the investing section of the statement of cash flows, with the rationale being these were cash inflows related to the purchases of property, plant and equipment. Under IFRIC 18, the credit side of the entry for any cash contributed will either be revenue or deferred revenue. Therefore, entities will have to present these cash payments within the operating section of the statement of cash flows.

Conclusion

Utility entities will have to exercise judgement in the adoption of IFRIC 18 - particularly to determine the fair value and to balance the indicators provided in IFRIC 18 with the specific facts and circumstance of their regulatory regime. Utility entities are also likely to find that different conclusions will be reached for different classes of customers (i.e., residential vs commercial). Therefore, an entity's accounting policy disclosures will be critical to a users understanding of the results and how they arrived at the appropriate conclusion.

IFRS monthly update

What's new this month?

The following table shows new exposure drafts issued by the IASB.

Projects	Publication	Status
Revenue recognition	<i>Exposure Draft (ED) – Revenue from Contracts with Customers</i> This ED proposes to create a single revenue recognition standard for IFRS and US GAAP. The proposed standard would replace IAS 18 <i>Revenue</i> , IAS 11 <i>Construction Contracts</i> and three IFRIC interpretations. View the ED at www.iasb.org See <i>Supplement to IFRS outlook</i> Issue 75 which contains details of the proposals and can be downloaded at www.ey.com/ifrs	Open for comment until 22 October 2010
Fair value measurement	<i>Exposure Draft (ED) – Measurement Uncertainty Analysis Disclosure for Fair Value Measurements</i> The ED proposes to require the disclosures to reflect the interdependencies between unobservable inputs used to measure fair value in Level 3 'unobservable inputs'. View the ED at www.iasb.org See <i>Supplement to IFRS outlook</i> Issue 77 which contains details of the proposals and can be downloaded at www.ey.com/ifrs	Open for comment until 7 September 2010
Financial statement presentation	<i>Staff draft of a proposed Exposure Draft (ED) on financial statement presentation</i> The draft ED proposes to fundamentally change the way that entities present their performance, financial position and cash flows. Before finalising and publishing an exposure draft, the IASB and FASB wish to engage in additional public outreach activities to consider whether any additional changes are necessary to their proposals on financial statement presentation. We will be issuing a Supplement to IFRS Outlook in the near term that will highlight the more significant aspects of the Boards' proposals.	

Current discussions

The IASB and the FASB held meetings on 1 June 2010, 10 June 2010 and from 14 to 17 June 2010.

Tentative decisions were made regarding a number of projects, including consolidation, insurance contracts, leases, joint arrangements, offsetting and liabilities. Further details can be found in the IASB Update, a summary of the tentative decisions reached by the Board at their meetings. This can be found at www.iasb.org/updates/IASB+updates.

Modification of IASB Work Plan

The IASB modified its work plan in June 2010 to focus on those projects for which the need for improvement of IFRS and US GAAP is the most urgent. See our Supplement to *IFRS outlook* Issue 76 which contains details of the modification. The current IASB work plan outlines all of the projects the Board is currently working on, and includes projected publications dates. Further details of all the ongoing projects can also be accessed at www.iasb.org/current+projects.

Change of name

The IASC Foundation changed its name to the IFRS Foundation on 1 July 2010.

Resources

Supplements to *IFRS outlook*

Issue 75: IASB and FASB propose a single revenue recognition model

This supplement summarises the key components of the IASB and the US FASB's joint proposal for a single revenue recognition model for most revenue transactions in their recently issued ED *Revenue from Contracts with Customers*. In brief, the proposed model:

- ▶ Determines that revenue will be recognised on individual elements when control of the contracted good or service is transferred to the customer
- ▶ Provides more detailed guidance than current IFRS on the accounting for certain transactions and requires significantly more disclosure than is currently required under IAS 18 *Revenue*
- ▶ Will affect the accounting for some components that are common to revenue transactions

It is likely that all entities will be affected by the new guidance. The comment period ends on 22 October 2010.

Issue 76: IASB and FASB focus on high priority projects

This publication summarises the modified work plan contained in the IASB and US FASB's jointly issued progress report for their major projects. The modified work plan focuses on those projects for which the need for improvement of IFRS and US GAAP is the most urgent. For these projects, the targeted completion date of June 2011, set by the G20 leaders at the Pittsburgh Summit in September 2009, has been retained. For other lower priority projects, or projects where further analysis is needed, a later completion date has been set.

Issue 77: Limited re-exposure of fair value measurement disclosures

This supplement explores a number of issues following the release of the IASB's June 2010 ED *Measurement Uncertainty Analysis Disclosure for Fair Value Measurements*. These include: the specific proposals of the ED for disclosures related to measurement uncertainty; how the ED fits in with the joint project with the FASB on Fair Value Measurements; and how the ED compares with current IFRS, the May 2010 ED and US GAAP.

Advertising and sponsorship – Accounting for promotional costs in consumer products companies under IFRS

Many consumer product companies spend significant amounts on marketing and promotion, often on campaigns that run over a number of years. In the light of recent IASB clarifications about the timing of the recognition of advertising and promotion costs, this publication considers some of the accounting principles that relate to these costs and the steps that management needs to take to find a sound accounting treatment under IFRS for these activities.

Key IFRS accounting developments for banks

Following the global financial crisis, a spotlight was focused on the complexity of accounting for financial instruments under IFRS. The IASB has accelerated its project to replace IAS 39 *Financial Instruments: Recognition and Measurement* and amend or replace several other standards. This publication provides an overview of some of the recent IFRS accounting developments and considers their potential impact for banks.

Key IFRS accounting developments affecting asset managers and funds

This publication summarises the key features of certain IASB projects and standards which may have a significant impact on financial accounting by asset managers and funds. Some of these projects are joint projects with the FASB, as part of ongoing efforts to converge IFRS and US GAAP. The accounting changes arising from the exposure drafts and tentative decisions are extensive and it is critical that feedback on potential issues is shared with the IASB before the standards are finalised.



Implementing Phase 1 of IFRS 9

The IASB published the first phase of IFRS 9 *Financial Instruments* which will eventually replace IAS 39 *Financial Instruments: Recognition and Measurement*. The first phase of the new standard covers the classification and measurement of all financial assets within the scope of IAS 39.

Whilst IFRS 9 is not mandatory until 1 January 2013, entities may adopt it earlier, subject to approvals necessary within each jurisdiction. Some jurisdictions have already endorsed IFRS 9, wherein a number of entities have adopted or are considering early adoption of the standard.

In a series commencing with this publication, we aim to address some of the key questions that are being asked about implementing IFRS 9, recognising that further issues and questions are likely to be raised when more entities apply the standard.

Coming soon

Impairment accounting – the basics of IAS 36 *Impairment of Assets*

This introductory publication provides an overview of the key requirements of IAS 36 *Impairment of Assets*, highlighting areas where it differs from US GAAP and some of the practical considerations for first-time adopters of IFRS.

Forthcoming IFRS webcasts

Tuesday 27 July 2010 – Revenue recognition under IFRS and US GAAP: proposed single model

This webcast will be broadcast twice in 24 hours. Go to ey.com/ifrs to register for the webcast that best fits your schedule.

On 24 June 2010, the IASB and the US FASB released a proposal to improve the accounting for revenue under both IFRS and US GAAP. The proposal is designed to provide a single revenue model for most transactions under both accounting frameworks. This would affect all entities and, for some IFRS reporters, the changes may be significant. Those most affected include: entities that recognise revenue using the percentage of completion method, e.g., construction industry, entities with multiple element arrangements and entities that give warranties on their products.

In this webcast, a panel of professionals will discuss the new exposure draft, focusing on the major building blocks of the model. These include: identifying the contract with a customer and the separate performance obligations in the contract; recognising revenue when the entity satisfies the performance obligations; determining the transaction price; and allocating the transaction price to the performance obligations. This webcast is aimed at helping CFOs and controllers to identify and address the proposed changes that the new model will bring.

September 2010 – Exposure Draft for insurance contracts – breaking news

Please note: this webcast and replay are tentatively scheduled. Please go to ey.com/ifrs to register for the webcast that best suits your scheduling needs.

With the IASB's planned ED for insurance contracts imminent, insurance professionals need a succinct summary of the key implications. The proposals for accounting for insurance contracts are likely to have a significant effect on all insurance companies. In this webcast, our panel of Ernst & Young LLP professionals will give a high-level review of the ED for insurance entities and will cover: likely implications for users and preparers of insurance entity financial statements; how this ED interacts with other IASB and FASB projects; and a comparison of IASB and FASB proposals.

Join our panel in this breaking news webcast, as they discuss the impact of the new ED and the upcoming proposals under IFRS 4. The panel will also offer participants the opportunity to raise key issues. This webcast is relevant to everyone connected with the financial reporting of insurance entities, in particular, senior management, the finance and actuarial community, auditors and audit committee members, as well as users of insurance entity financial statements.

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