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ACCOUNTING NEWS

IN THIS EDITION

In this edition, we look at proposed changes to the dividend rules in the *Corporations Act 2001*, as well as two recent amendments to accounting standards issued by the International Accounting Standards Board (IASB). We also look at a roundup of issues raised on the IFRS 3 post-implementation review at the recent Australian Accounting Standards Board's roundtable. Finally, read more on the new hedging rules; - effectiveness testing will be simpler under AASB 9 *Financial Instruments*, and the IASB's Discussion Paper on macro hedging.

PROPOSED CHANGES TO CORPORATIONS ACT – DIVIDENDS AND OTHER PROPOSALS

IN APRIL 2014, THE GOVERNMENT ISSUED AN EXPOSURE DRAFT OF THE *CORPORATIONS LEGISLATION AMENDMENT (DEREGULATORY AND OTHER MEASURES) BILL 2014* WHICH COMPRISES A PACKAGE OF REPEAL AND STREAMLINING AMENDMENTS TO THE *CORPORATIONS ACT 2001* (CORPORATIONS ACT) AND THE *ASIC ACT 2001*. THE CHANGES ARE EXPECTED TO REDUCE COMPLIANCE COSTS FOR BUSINESSES.

The main proposed changes impacting financial reporting and audit include:

- Dividends – s254T
- Directors' reports – s300(1)
- Remuneration reports – s300A
- Financial years – s323D(2A)
- Companies limited by guarantee – auditor appointment – s327A(1) and s327B(1)
- General meetings requested by 100 shareholders – s249D(1).

There is a short consultation period for this Exposure Draft, with comments closing 16 May 2014.

Dividends

Current position

Section 254T(1)

A company must not pay a dividend unless:

(a) The company's assets exceed its liabilities immediately before the dividend is declared and the excess is sufficient for the payment of the dividend; and

(b) The payment of the dividend is fair and reasonable to the company's shareholders as a whole; and

(c) The payment of the dividend does not materially prejudice the company's ability to pay its creditors.

Following on from the redraft of the Corporations Act in 2010, there were various problems identified with the mechanism of the dividend provisions in s254T. These include:

- The ability to pay a dividend is expressed in prohibitive (must not pay a dividend unless…) rather than permissive (can pay a dividend if...) terms. This prohibitive wording inappropriately and unnecessarily restricts dividend payments to current year profits and balances of retained earnings.
- s254T(1) fails to adequately identify the funds out of which a company is authorised to pay dividends, e.g. share capital, retained earnings, other reserves, etc.
- The net assets test (s254T(1)(a)) was introduced to address concerns that changes to the accounting standards (IFRSs) had made the calculation of profits more difficult, limiting the company's ability to pay dividends under the previous profits-based dividends test. However, many stakeholders argue that net assets is not an effective measure of solvency, and that Part 2J of the Corporations Act limits the ability of companies to pay dividends out of capital anyway.
- s254T(1) refers to paying and declaring dividends which can be confusing, given the two sets of rules for paying dividends (declaration allowed by company constitutions vs. s254U replaceable rules).
- Small proprietary companies that are not otherwise required to prepare financial statements in accordance with Accounting Standards incur unnecessary, significant compliance costs in order to demonstrate they had legally paid a dividend.

Proposals

The purpose of the Exposure Draft is to address some of the problems with the current section and is proposed to be redrafted as follows:

s254T Circumstances in which a dividend may be declared or paid

Declaration of dividends

1. A company must not declare a dividend unless, immediately before the dividend is declared, the directors of the company reasonably believe that the company will, immediately after the dividend is declared, be solvent.

Note: For a director's duty to prevent insolvent trading on payment of dividends, see section 588G.

Payment of dividends without declaration

2. A company must not pay a dividend unless, immediately before the dividend is paid, the directors of the company reasonably believe that the company will, immediately after the dividend is paid, be solvent.

Note: For a director's duty to prevent insolvent trading on payment of dividends, see section 588G.

3. Subsection (2) does not apply to a dividend that is declared.

The proposals will rectify most of the problems identified because:

- There will be a solvency test only
- The net assets test has been removed, eliminating the need for reference to Accounting Standards, which will save small proprietary companies time and money
- Separate sections will be introduced for paying dividends (s254T(1)) and declaring dividends (s254T(2)).

Unfortunately, the redrafted section is still written in prohibitive language, which means there is still uncertainty:

- Over which accounts a dividend can be paid from (e.g. share capital, revaluation reserves, retained earnings, profit, etc.)
- Whether profits are required in order to pay/declare a dividend.

However, these issues have been addressed by proposed s254TA (see discussion below) which clarifies that a capital reduction can be made via a dividend payment, provided that it is done via an equal reduction to all shareholders. This is a cost-saving measure because companies will not have to hold a general meeting as required by s256C.

254TA Share capital reductions by way of dividends

1. A company may reduce its share capital by declaring or paying a dividend, if:
   (a) The dividend is declared or paid, as the case may be, in accordance with section 254T; and
   (b) The reduction in share capital is an equal reduction.
2. For the purposes of paragraph (1)(b), the reduction is an equal reduction if:
   (a) It relates only to ordinary shares; and
   (b) It applies to each holder of ordinary shares in proportion to the number of ordinary shares they hold; and
   (c) The terms of the reduction are the same for each holder of ordinary shares, disregarding differences that are:
      (i) Attributable to the fact that shares have different accrued dividend entitlements; or
      (ii) Attributable to the fact that shares have different amounts unpaid on them; or
      (iii) Introduced solely to ensure that each shareholder is left with a whole number of shares; or
      (iv) Attributable to the use of dividend reinvestment plans.

Note: There will be no change in the tax consequences of dividends as a result of these proposed amendments. Dividends paid out of share capital for income tax purposes will therefore not be dividends and not be 'frankable' and will cause a reduction on the capital gains tax cost base of recipient shareholders.

Directors' reports

Changes are also being proposed to the directors' report requirement for disclosure of dividends. Directors will also need to disclose details of:

- Source of dividends paid (s300(1)(a))
- Company's dividend policy when paid out of sources other than profits (s300(1)(ba)).

Remuneration reports

Various changes are also proposed to improve disclosures in remuneration reports and to streamline some of the requirements. Some of the main proposals include:

- Remuneration reports will only be required for listed companies (s300A(2)). Unlisted companies that are disclosing entities will no longer be required to prepare remuneration reports.
- Service contract details will be deleted (s300A(1)(e)(vi)). This is a superfluous requirement as details are required in any event by Regulation 2M.3.03(1) item 13.
- For options that lapse during the period, only the number and year of grant will need to be disclosed. The dollar value of options that lapsed during the period will no longer be required (s300(1)(e)(iv)).
- The remuneration report will need to include a description of the company's process (remuneration governance framework) for determining key management personnel remuneration, or details of where such information can be found in the annual report (s300A(1)(aa)).

Financial years

S323D(2A) allows financial years to be changed no more than once in a five year period. The amendments propose a note to be added to s323D(2A) to clarify that the following cases are disregarded when determining whether the financial year has changed in the previous five years:

- Financial years that are more or less by seven days by virtue of s323D(2)
- Financial years that have been changed to facilitate synchronisation by virtue of s323D(4).

Companies limited by guarantee – auditor appointment

The 2010 amendments to the Corporations Act removed the need for small and medium-sized companies limited by guarantee to have their financial reports audited. However, these companies are still required to appoint an auditor and fill vacancies in the auditor position.

S327A(1A) is a new section proposing that small and medium-sized companies limited by guarantee do not need to appoint an auditor within one month of registration if the directors reasonably believe that the entity is a small or medium-sized company limited by guarantee.

S327B(1A) is also a new section proposing that small and medium-sized companies limited by guarantee do not need to appoint an auditor at the first annual general meeting or to fill a casual vacancy.

General meetings requested by 100 shareholders

S249D(1) will be amended to delete the requirement for directors to arrange a general meeting, paid for by the company, at the request of 100 members entitled to vote at the annual general meeting (the 100 member rule). This will reduce costs because in large companies, 100 members may hold a very small percentage of voting shares.

Directors will still be required to hold a general meeting at the request of shareholders with at least 5% of voting shares.

What next?

We will endeavour to update you on progress of this Bill when it is tabled in Parliament and passes through both Houses.

CHANGES TO IFRS 11 *JOINT ARRANGEMENTS* – ACCOUNTING FOR ACQUISITIONS OF INTERESTS IN JOINT OPERATIONS

Background

A previous submission to the IFRS Interpretations Committee identified diversity in practice regarding the accounting for acquisitions of interests in joint operations that constitute a business under IFRS 3 *Business Combinations*. Three approaches were identified in practice:

- **IFRS 3 approach** – Measure identifiable assets and liabilities at fair value, residual allocated to goodwill, acquisition costs expensed and deferred taxes recognised on initial recognition of assets and liabilities.
- **Cost approach** – Total cost of acquiring interest in joint operation allocated to individual identifiable assets and liabilities on basis of their relative fair values (Premium allocated to individual assets rather than goodwill). No deferred tax recognised and acquisition costs capitalised.
- **Hybrid approach** – Identifiable assets and liabilities measured at fair value and residual recognised as goodwill. Acquisition costs capitalised. Contingent liabilities and deferred tax not recognised.

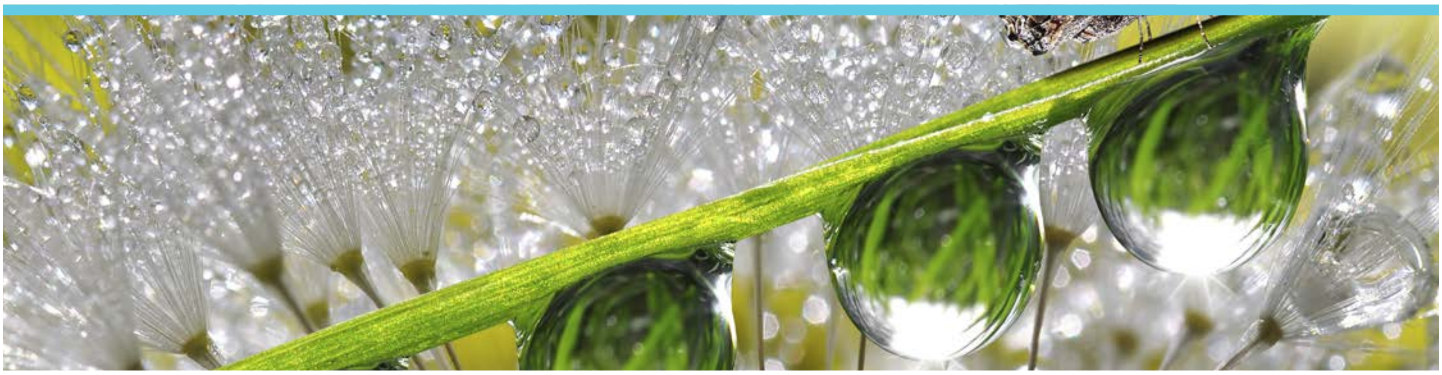
This diversity resulted in the International Accounting Standards Board (IASB) issuing an Exposure Draft in December 2012 to clarify the appropriate accounting treatment, and now a final standard, IASB amending document, *Accounting for Acquisitions of Interests in Joint Operations – Amendments to IFRS 11*. At the time of writing, these amendments had not been approved as local amendments by the Australian Accounting Standards Board (AASB).

Accounting for joint operations

Prior to these amendments, the only accounting guidance for joint operators was included in AASB 11, paragraph 20, which basically requires joint operators to account for what belongs to them, i.e. **its** assets, **its** liabilities, **its** revenue and **its** expenses, including its share of anything held or incurred jointly.

What are the changes?

The amendments expand on this guidance by adding paragraph 21A to



IFRS 11. Paragraph 21A requires that when an entity acquires an interest in a joint operation whose activities constitutes a **business**, it must apply all the principles of IFRS 3 *Business Combinations*, and other IFRSs, as long as these principles do not conflict with the guidance in IFRS 11.

The changes apply to:

- The acquisition of the initial interest in a joint operation
- The acquisition of additional interests in a joint operation
- Cases where an existing business is contributed to a joint operation on formation by one of the parties that participate in the joint operation.

What will this mean in practice?

In practice, this means that we will see the following where interests in joint operations constitute a business:

- Identifiable assets and liabilities to be measured at fair value (unless exception in IFRS 3 or other IFRSs)
- Acquisition costs to be expensed, unless they relate to the costs of issuing debt or equity, which are to be accounted for under IAS 32 *Financial Instruments: Presentation*
- Deferred tax assets and liabilities that arise on initial recognition of an asset or liability (except for goodwill) to be recognised
- Residual consideration to be recognised as goodwill
- Annual goodwill impairment testing of cash-generating units to which goodwill relates, or whenever there is an indication of impairment under IAS 36 *Impairment of Assets*.

This 'business combination accounting' will not be required where an interest is acquired in a joint operation that is a business from another entity that is under common control of the ultimate controlling party.

Acquiring additional interests

Where a joint operator acquires an additional interest in a joint operation that constitutes a business, previously held interests are not remeasured if the joint operator retains joint control.

Example

Example 7 has been added to IFRS 11. We have adapted Example 7 to illustrate how the accounting process works.

Companies A, B and C have joint control over Joint Operation D, whose activity constitutes a business.

Company E acquires Company A's 40% ownership interest in Joint Operation D for $300 and incurs further acquisition costs of $50.

The contractual agreement between the three parties specifies that Company's E share in several assets and liabilities differs from its 40% ownership interest. Column B in table below shows Company E's specified percentage interest in assets and liabilities per the contractual agreement.

Four step process

When accounting for its 40% interest in Joint Operation D, Company E needs to:

- Firstly determine its percentage entitlement and obligation for each asset and liability of Joint Operation D (Column B)
- Secondly, determine IFRS 3 fair value or other measures of Joint Operation D (Column A),
- Thirdly, determine the amounts to be recognised in its financial statements (Column C)
- Lastly, calculate goodwill (consideration less Column C).

	COLUMN A	COLUMN B	COLUMN C (COLUMN A X COLUMN B)
	Fair value or other measure specified by IFRS 3 for Joint Operation D's assets and liabilities $	Company E's share in these assets and liabilities $	Amounts recognised in Company E's financial statements $
PPE	288	48%	138
Intangible assets (excluding goodwill)	80	90%	72
Accounts receivable	210	40%	84
Inventory	175	40%	70
Retirement benefit obligations	(80)	15%	(12)
Accounts payable	(120)	40%	(48)
Contingent liabilities	(93)	56%	(52)
Deferred tax liability **(assume includes deferred tax liability on fair value of intangible assets of $80)**	(60)	40%	(24)
NET ASSETS	**400**		**228**

The net assets of Joint Operation D are $400 and Company E's share is $228. You can see that Company E's share of $228 does not equate to 40% (its ownership interest) of $400.

Goodwill is calculated as follows:

	$
Consideration	300
Company E's share of identifiable assets and liabilities	<u>(228)</u>
Goodwill	**<u>72</u>**

Acquisition-related costs of $50 are expensed in profit or loss when incurred.

Effective date

These amendments apply prospectively to annual periods beginning on or after 1 January 2016 and can be adopted early. This means that the new requirements must be applied to acquisitions of interests in joint operations (that constitute a business) occurring on or after the beginning of the first period in which the amendment applies (e.g. 1 January 2016 for entities with a 31 December year end and 1 July 2016 for entities with a 30 June year end).

Acquisitions occurring in prior periods are <u>not</u> adjusted retrospectively.

Action point

In theory, new and amended accounting standards cannot be adopted until approved by the AASB. However, these amendments are merely clarifying common practice, and we therefore recommend that you adopt these practices for acquisition of interests in joint operations from 1 July 2013.

IASB CLARIFIES ACCEPTABLE METHODS OF DEPRECIATION AND AMORTISATION

ON 12 MAY 2014, THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) ISSUED AMENDMENTS TO IAS 16 *PROPERTY, PLANT AND EQUIPMENT* AND IAS 38 *INTANGIBLE ASSETS* WHICH CLARIFY ACCEPTABLE METHODS OF DEPRECIATION AND AMORTISATION.

Changes to IAS 16

Paragraph 62A has been added to IAS 16 to clarify that use of revenue-based methods for calculating depreciation is not appropriate because revenue generated by an activity that includes the use of an asset generally reflects factors other than the consumption of economic benefits embodied in the asset. For example, revenue is affected by other inputs and processes, selling activities and changes in sales volumes and prices. The price component of revenue may be affected by inflation, which has no bearing on the way in which an asset is consumed.

Changes to IAS 38

Similar changes have been made to IAS 38 with the introduction of paragraph 98A, except that this paragraph includes a rebuttable presumption that can be overcome only in the following limited circumstances:

- The intangible assets is expressed as a measure of revenue
- It can be demonstrated that revenue and the consumption of economic benefits of the intangible asset are highly correlated.

The following examples are provided in paragraph 98C of cases where a revenue-based amortisation basis may be appropriate:

- Concession to explore and extract from a gold mine expires when total cumulative revenue from extraction of gold reaches $2 billion, rather than expiring on a set date or ounces of production
- Right to operate a toll road expires when tolls generated from operating the toll road reach $100 million, rather than at a set date or based on number of vehicles.

These revenue thresholds are referred to in the amendments as 'predominant limiting factors'. When revenue is the 'predominant limiting factor' in the contract for use of the intangible asset, revenue generated may be an appropriate basis for amortising the intangible asset, provided that the contract specifies a fixed total amount of revenue to be generated on which amortisation can be determined.

Effective date

The amendments apply prospectively to annual periods beginning on or after 1 January 2016, with early adoption permitted.

How do we account for a change in method of depreciation or amortisation?

If you currently adopt a revenue-based depreciation/amortisation method, on first-time adoption of these amendments on 1 January 2016, you will <u>not</u> be required to go back and retrospectively recalculate depreciation and amortisation using a non-revenue based method. Instead, you will merely apply the new method from 1 January 2016. This is because IAS 16, paragraph 61 and IAS 38, paragraph 104 stipulate that changes in the depreciation/amortisation methods are accounted for as **changes in accounting estimates** under IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*. IAS 8, paragraph 36 requires that changes in accounting estimates are accounted for prospectively.

This treatment is in line with the prospective transitional requirements in this standard. IAS 8, paragraph 39, also requires disclosure of the following for changes in accounting estimates:

- Nature of the change
- Amount of change that has an effect on the current period
- Amount of change(s) that will affect future period(s) (unless impracticable to estimate, in which case that fact must be disclosed).

How should we depreciate/amortise new assets?

For new assets acquired during the current financial year, we recommend that you do <u>not</u> adopt a revenue-based depreciation/amortisation method because these changes are merely clarifying current practice, and it will save you having to change to another method in 2016.

Even though a revenue-based depreciation/amortisation method is permitted until 2016, it is our view that persisting with a policy that is about to be prohibited is unusual. We therefore recommend that you consider changing your depreciation and amortisation methods for existing assets. These changes in methods will be recognised as changes in estimates under IAS 8 and no retrospective adjustments to assets balances will be required. However, IAS 8, paragraph 39 disclosures will be required as described above.

AASB ROUNDTABLE FOR POST IMPLEMENTATION REVIEW OF IFRS 3

AS PART OF THE AASB'S PROCESS FOR RESPONDING TO THE *IASB'S REQUEST FOR INFORMATION ON THE POST-IMPLEMENTATION REVIEW: IFRS 3 BUSINESS COMBINATIONS* (RFI), THE AUSTRALIAN ACCOUNTING STANDARDS BOARD (AASB) HOSTED A ROUNDTABLE DISCUSSION AT THEIR MELBOURNE OFFICES ON 30 APRIL 2014.

The discussion was attended by representatives of the major accounting firms, industry, and interested consultants. Also present were members of the AASB and a number of AASB staff members. The session was observed by an IASB staff member on video link from the UK and was chaired by Kevin Stevenson, Chair of the AASB.

Summary

Perhaps it is best starting with a summary of the discussion. The general conclusion reached was that IFRS 3 is not broken, does not need fixing and the IASB should put its effort into other more pressing projects such as addressing common control transactions. A lot of the discussion really centred around deficiencies and inconsistencies with other standards (IAS 16 *Property, Plant and Equipment*, IAS 36 *Impairment of Assets* and IAS 38 *Intangible Assets*) rather than direct concerns with IFRS 3.

Kevin Stevenson finished the meeting noting that although we had enjoyed a robust intellectual discussion about the detailed application of IFRS 3, he had concerns that we had side-stepped a number of the direct questions asked by the IASB in respect to whether the information provided by IFRS 3 was either useful or gave benefits to the user.

Professor Tarca noted that many of the questions asked by the IASB were not areas addressed by the accounting academia, so empirical studies as to whether this information was useful or not, would not be adequately addressed by available research.

Goodwill is 'porridge'

A wonderful new phrase was introduced at the roundtable referring to goodwill as 'porridge', i.e. made up of items of unknown elements and consistency.

This 'porridge' is allowed to stay on the balance sheet, gradually changing overtime, its continued recognition being justified by cash flows arising from operations that have little, if any, connection to the 'porridge' that was originally acquired as part of a business combination.

Is the recognition of goodwill, and either its impairment or amortisation, useful?

"What information do analysts find useful?" was a question pondered by the participants. It would appear that amortising goodwill over 20 years is simply backed out and ignored by analysts. However there did appear to be acknowledgement that impairment write-offs were noticed and 'useful' to users.

There was a debate as to whether the write down of goodwill simply lagged behind adjustments that analysts already knew, or represented new information creating a price fall, which was an indicator of an ill informed market.

Professor Peter Wells of the University of Technology, Sydney, noted that studies had shown that impairment write downs of goodwill occurred when a management change occurred. This could represent new management having a more open, realistic view of the future and past acquisitions, or it could represent the unwritten principle that if you are having a bad year, make it really bad! The sceptical question was also raised as to whether this 'prudent view' was driven by share options issued to new management, that would benefit from a lower share price on issue and would find profit targets or market performance targets easier to achieve, without future impairment charges.

It was further recognised that poor performance does usually trigger management change so the correlation of impairment write downs to management change could simply be a time lag of bad news being reported in the financial report. This bad news triggered a management change.

What is in the 'porridge'?

Some participants called for greater clarification of what is goodwill. If it is an existing workforce and synergies, then what is the basis for this having an indefinite useful life? Should the 'porridge' be amortised over a much shorter period, say three years?

There appears to be an apparent inconsistency in that the 'porridge' of acquired goodwill regenerates itself, a practice flying in the face of the treatment for acquired customer lists and the prohibition of capitalising internally generated goodwill.

It was noted that acquired goodwill, having been allocated to a specific cash-generating unit (CGU), could somehow metamorphose from a steam driven business, to an analogue business to a digital business… and now be 'in the cloud'. These issues are arguably an issue for correction in IAS 36 (impairment), or even IAS 38 (intangibles), rather than a true failing of IFRS 3.

Amortise goodwill

The majority of the representatives of the large accounting firms expressed the view that, at an international level, they were seriously considering whether to recommend the amortisation of goodwill.

Other issues on goodwill

Does it make sense that additional goodwill arises from an increase in the acquirer's share price between the date that the deal is agreed and the acquisition date, being the date that the fair value is determined between willing buyers and willing sellers?

It was suggested that there should be a rebuttable presumption that the element of goodwill arising from this type of situation is impaired, either immediately through profit or loss or even directly debited to equity.

Single asset purchases

Another issue raised was the impact of recognising 'goodwill' on the purchase of single asset businesses, specifically mines. In these instances, there is no initial recognition exemption for recognising deferred tax where the tax base of the mine differs from the accounting carrying value. This effectively results mathematically in the recognition of goodwill, which may not reflect either an existing work force or synergies. This amount can be difficult to justify when testing goodwill for impairment.

Other criticisms of goodwill impairment testing were in respect of the lack of guidance and precision applied in allocating goodwill to specific CGUs, particularly in terms of identifying and valuing 'synergies' to existing CGUs.

Bargain purchase prices

There was also general cynicism and scepticism from participants as to the likelihood of a bargain purchase price, given that the transaction was between willing parties. Kevin Stevenson noted that he had seen at least two major transactions that did indeed represent a bargain purchase price.

The inconsistency between IAS 38 and the requirement to recognise a bargain purchase price in IFRS 3 was noted. IAS 38 expressly prohibits the revaluation of intangibles, including brands, mastheads etc., on the basis that the intangible cannot be reliably measured. This simply does not correlate to the recognition of a bargain purchase price, where the value of the intangible assets acquired are determined to be in excess of the consideration paid.

Gross up of non-controlling interests (NCI)

There was widespread agreement amongst participants that under IFRS 3, preparers are not grossing up goodwill in respect of NCI. There was general debate whether the option to gross up goodwill should be removed. Kevin Stevenson reminded participants that grossing up NCI was the only option under US GAAP, and that the non-gross up method allowed under IFRS 3 had very little theoretical justification and questioned the usefulness and logic for including it.

Recognising identifiable intangibles separately from goodwill

There was a great deal of debate has to how useful it was to recognise intangibles separately from goodwill, and the practicalities associated with assigning values to these intangibles.

Practical issues raised on valuing intangibles centred on the fact that these assets are not separately valued or sold, and the significant judgement involved in assigning value. The range of values assigned could be large, with examples being quoted where participants had seen that the highest value for an identified intangible being twice the lowest value. It was also noted that the values given critically depend upon the exact scope given to the valuers.

It was recognised that since the revision of IFRS 3 in 2008, which removed the requirement for intangibles to be able to be reliably measureable, the number and quantum of intangibles had increased. However the original belief of the standard setters when the original IFRS 3 was released was that goodwill would only represent a small, or relatively small, proportion of the assets acquired. Application of US GAAP, which contains the same wording as IFRS 3, has seen significantly less goodwill recognised (and correspondingly more value attributed to acquired intangibles).

Kevin Stevenson noted that current Australian tax law, specifically as it applies to the claiming of deductions for intangibles, could well change current practice, and preparers would be well advised to consider their tax planning when instructing valuers on the valuation of acquired intangibles.

Definition of a business

This was recognised to be a key starting point as to the difficulties associated with this area of accounting. There are significant differences in accounting for business combinations compared with asset acquisitions. Asset acquisitions allow the capitalisation of acquisition costs, include an initial recognition exemption for recognising deferred tax, do not have a concept of bargain purchase price, ignore 'goodwill' arising from synergies achieved as a result of buying an asset or group of assets, and has unclear accounting for the accounting for deferred consideration.

There appears little justification for many of these differences. It was suggested that resolving and reducing the differences could remove the importance and focus on determining the difference between a business combination and an asset acquisition. These changes most likely involve changing the accounting for asset acquisitions.

There is also significant confusion arising from the application guidance attached to the standard. IFRS 3 states that a business comprises inputs, processes and outputs. It recognises that current outputs are not always required for a business classification to be achieved. Confusion does arise, however, from the implementation guidance as a result of the acquired set of assets not having to possess all of the processes required to produce an output. The question was posed: 'Is acquiring 20 cars, with no processes or drivers, etc. a business?' The answer: 'It depends!'.

It was noted that the purchase price of an asset may vary by individual acquirers, and thus the 'market price' may be lower than the price a particular buyer might pay. This premium could be attributed to synergies that a specific acquirer expects to benefit from and these synergies may not be available to other market participants, or one of the purchasers may have a particularly strong brand or reputation which will allow that specific purchaser to earn a premium from the future use of the asset. The example given was the acquisition of shopping centres by a leading shopping centre manager, with a very well recognised brand and an experienced management team and letting division. In these cases, even on the acquisition of an asset, should some of the purchase price be allocated to goodwill?

Other issues raised

Question 9 of the RFI for comment covered 'any other issues arising from IFRS 3'. The main issue raised by representatives of the major firms was in respect of the accounting for deferred consideration to vendors that included a service condition, i.e. the owner receives $1 million additional consideration should an EBIT target be achieved, and he stays in employment to a specified date. Under IFRS 3, none of this deferred consideration would be treated as consideration, but instead would be accounted for as a post-acquisition service expense. The general concern raised by participants was that the accounting simply did not represent the substance of the transaction, and that the current requirements of IFRS 3 were causing contracts to be modified in order to achieve the correct accounting.

Comments due

Comments on the RFI were due to the AASB by 2 May 2014 and the IASB by 30 May 2014. BDO will be making a submission to the IASB (Refer to Comment letters on IFRS standard setting after 30 May 2014).

SIMPLER EFFECTIVENESS TESTING UNDER AASB 9 *FINANCIAL INSTRUMENTS*

Introduction

AASB 9 (2013) *Financial Instruments* issued by the Australian Accounting Standard Board (AASB) includes the requirements of the new hedge accounting model. The new hedge accounting model under AASB 9 is less complex and provides better links to entities' risk management activities. The hedge effectiveness testing requirements under AASB 9 are less onerous and complex.

This article provides an overview of the new hedge effectiveness testing requirements under AASB 9.

What's no longer required?

The 80-125% quantitative threshold criterion for applying hedge accounting under AASB 139 *Financial Instruments: Recognition and Measurement* has been removed. Entities are no longer required to perform a retrospective test. Depending on the circumstances, a quantitative prospective test may not be necessary.

The removal of the 80-125% quantitative threshold means that even if, at the end of a reporting period, the hedge was only 70% effective, the entity would recognise 30% of ineffectiveness in profit or loss but would not discontinue hedge accounting. (In contrast, under the AASB 139 model the entity would have to discontinue hedge accounting because retrospective effectiveness of 70% is not within the 80-125% range.)

The new requirements

The new hedge effectiveness testing requirement contains three criteria:

- Existence of an economic relationship
- Effect of changes in credit risk is insignificant
- The hedge ratio applied for hedge accounting is the same as the ratio applied for risk management purposes.

NEW HEDGE QUALIFICATION CRITERIA		
Existence of an economic relationship	Effect of changes in credit risk is insignificant	Apply the same hedge ratio as risk management

Existence of an economic relationship

The first criterion requires that an economic relationship exists between the hedged item and the hedging instrument. This means that the hedging instrument and the hedged item must be expected to have offsetting fair values.

For example, an entity with an Australian functional currency might sell goods or services to customers overseas in US dollars. If the Australian entity enters into a forward contract to exchange US dollars for AUD on a specified future date (to coincide with the expected date of US dollar payments by customers), changes in the fair value of that forward contract would be expected to offset changes in the fair value of cash to be collected that is denominated in US dollars.

Effect of changes in credit risk is insignificant

The second criterion is that the fair value changes due to credit risk should not be a significant driver of the fair value changes of either the hedging instrument or the hedged item.

For example, an entity enters into a commodity forward contract to hedge future commodity sales. Due to deteriorating and volatile economic conditions, the counterparty to the commodity forward (a bank) is in financial distress and is near bankruptcy. The commodity derivative is an asset to the entity (i.e. liability to the bank). The change in fair value of the derivative due to the deterioration in the bank's credit status dominates the change in fair value the derivative (rather than the changes in commodity prices). Under this scenario the commodity derivative would not qualify for hedge accounting.

Apply the same hedge ratio as risk management

The third criterion is that the hedge ratio applied for hedge accounting purposes is the same as the hedge ratio used for risk management purposes.

For example, an entity enters into a $10 million pay-fixed-receive-floating interest rate swap to manage its exposure to floating interest arising from a $10 million floating interest rate loan. The entity should designate the $10 million interest rate swap as the hedging instrument and the $10 million floating interest rate loan as the hedged item.

What this means

Under AASB 9, only prospective hedge effectiveness testing is required.

For simple vanilla interest rate swaps and foreign exchange hedges in which the currency, amounts, maturity and other critical terms match, it is expected that the new requirements will be simpler to apply and make qualifying for hedge accounting easier. It is expected that entities will be able to satisfy the above hedge effectiveness testing criteria by applying a qualitative 'critical terms match' test.

For more complex hedging relationships, such as where the hedged item is of a different grade to the hedging instrument (e.g. where a basis difference exists) or the derivative entered into is a more complex structured instrument a more detailed quantitative test is likely to be required. It may also involve entities exercising additional judgement. This may include:

- Establishing an appropriate hedge ratio
- Establishing whether or not an economic relationship exists
- Determining whether a quantitative test should be applied or whether a qualitative test is sufficient.

Where to from here

For clients that currently apply hedge accounting under AASB 139, early adopting the new hedge accounting can result in less onerous effectiveness testing requirements (in particular for foreign currency risk and interest rate risk). This can mean a reduction in time and costs spent to comply with the effectiveness testing requirements. Current hedges that are AASB 139 hedge accounting compliant can be treated as continuing hedges under AASB 9. For clients that do not currently apply hedge accounting, early adopting the new hedge accounting model can result in less profit or loss volatility from the use of derivatives.

If you would like more information on IFRS 9 and the revised hedging requirements, please contact Judith Leung. Judith was formerly a staff member at the IASB and was part of the team that developed this new model.

IASB ISSUES DISCUSSION PAPER ON MACRO HEDGING

IN APRIL 2014, THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) PUBLISHED A DISCUSSION PAPER DP/2014/1 *ACCOUNTING FOR DYNAMIC RISK MANAGEMENT: A PORTFOLIO REVALUATION APPROACH TO MACRO HEDGING* (THE DP).

The DP outlines a possible accounting approach for an entity's dynamic risk management activities, often referred to as macro-hedging. If the proposals in the DP are finalised it would represent a significant change in accounting for financial institutions that manage its exposure to interest rates on a dynamic basis. Other non-financial institutions that engage in macro hedging could also be affected.

In 'macro-hedging', the amounts of both the hedging instrument and the hedged item change constantly (on a daily, hourly or a more frequent basis). Financial institutions, such as banks, often use a macro-hedging strategy to manage their interest rate risk exposure arising from a portfolio of financial assets and liabilities e.g. hedging the net position of fixed rate financial assets and fixed rate financial liabilities.

The existing requirements in IAS 39 *Financial Instruments: Recognition and Measurement* assumes a 'static' hedging relationship (i.e. no new exposures can be added or existing exposures can be removed). Banks have found the existing IAS 39 requirements difficult to apply because the IAS 39 model does not capture the 'dynamic' nature of macro-hedging activities.

The DP considers a portfolio revaluation approach (PRA) as a possible way of better reflecting dynamic risk management in an entity's financial statements. Under the PRA, an entity would adjust the exposures that are being dynamically risk managed to reflect the effect of changes in value that arise from the managed risk i.e. only the managed risk is revalued - the managed exposures (assets and liabilities) would not be measured at fair value in their entirety. Any derivatives used to mitigate the risk would be measured at fair value through profit or loss (FVTPL). Consequently, the net effect of the risk management activities would be reflected in profit or loss.

The DP also explores the possible inclusion of exposures that are often within the bank's managed portfolio but are currently not eligible hedged items under IFRS 9 *Financial Instruments* or IAS 39. These include:

- Behaviouralisation (i.e. managing cash flows based on behavioural expectations rather that contractual terms)
- Deemed exposures arising from pipeline transactions (e.g. forecast drawdowns on fixed rate products at advertised rates)
- The equity model book (in which dynamic interest rate management is used with the intention of achieving a fixed notional base return on the bank's own equity).

In addition, the IASB's intention is that the PRA would also apply to dynamic risk management of other risks e.g. foreign exchange risk, commodity price risk, etc. The IASB is using this DP to seek feedback about how the approach could be applied to other risks (e.g. foreign currency risk and commodity price risk). Therefore, other non-financial institutions that engage in dynamic risk management activities could also be affected.

The DP represents the first stage of the IASB's project to develop a new macro hedging model which will replace the existing requirements in IAS 39 on fair value hedge accounting for a portfolio hedge of interest rate risk. Because the development of a new macro hedging model takes time, it has been made a separate project and will be issued as a separate standard from IFRS 9.

The IASB has requested comments on the DP by 17 October 2014.

NEW BDO PUBLICATIONS

The Audit section of our website includes a range of publications on IFRS issues. Look for the 'Global IFRS Resources' link which includes resources such as:

IFRS at a Glance – 'one page' and short summaries of all IFRS standards.

IFRS News at a Glance – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators.

Need to Knows – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include IFRS 9 *Financial Instruments* (May 2014), Hedge Accounting (IFRS 9 *Financial Instruments)* (Jan 2014), IFRS 11 *Joint Arrangements* (Dec 2013) and IFRS 13 *Fair Value Measurement* (Dec 2013).

IFRS in Practice – practical information about the application of key aspects of IFRS, including industry specific guidance. Recent IFRS in Practice include IAS 7 *Statement of Cash Flows*, Distinguishing between a business combination and an asset purchase in the extractives industry (March 2014), IAS 36 *Impairment of Assets* (Dec 2013) and Common Errors in Financial Statements – Share-based Payment (Dec 2013).

Comment letters on IFRS standard setting – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include IASB ED 2013 11 – Annual Improvements to IFRSs (2012-2014 Cycle), IASB ED 2013-10 *Equity Method in Separate Financial Statements* and IASB ED 2013-9 *IFRS for SMEs Review*.

COMMENTS SOUGHT ON EXPOSURE DRAFTS

At BDO, we provide comments locally to the Australian Accounting Standards Board (AASB) and internationally to the International Accounting Standards Board (IASB). We welcome any client comments on exposure drafts that are currently available for comment. If you would like to provide any comments please contact Wayne Basford at wayne.basford@bdo.com.au.

DOCUMENT	PROPOSALS	COMMENTS DUE TO AASB BY	COMMENTS DUE TO IASB BY
ED 249 *Disclosure Initiative (Proposed amendments to AASB 101)*	Issued as a result of the IASB's Disclosure Initiative, which was started in response to concerns raised by respondents to the IASB's *Agenda Consultation* in 2011. The ED proposes changes to AASB 101 *Presentation of Financial Statements* relating to materiality, line items in financial statements, notes to the financial statements and accounting policies. Also proposes changes as a result of a recommendation by the IFRS Interpretations Committee relating to disclosure of items of other comprehensive income relating to equity accounted investments.	30 June 2014	23 July 2014
Tier 2 Supplement to ED 249 *Disclosure Initiative (Proposed amendments to AASB 101)*	Proposes to exclude the proposed disclosure in ED 249, paragraph 85B, which requires reconciliation between additional totals and subtotals provided under AASB 101, paragraph 85 and those required under AASB 101.	30 June 2014	N/A
ITC 30 *Request for Comment on IASB Request for Information on Post-implementation Review: IFRS 3 Business Combinations*	This post-implementation review is part of the IASB's due process to review major new standards, or significant amendments to existing standards, to ensure they are working as intended.	2 May 2014	30 May 2014
ITC 31 *Accounting for Dynamic Risk Management: a Portfolio Revaluation Approach to Macro Hedging*	Invites comments on the approach to macro hedge accounting put forward in the IASB's Discussion Paper (DP). The DP assesses whether an accounting approach that reflects how entities manage risk dynamically is necessary to help users of financial statements to understand risk management activities. Specifically the DP considers whether the portfolio revaluation approach (PRA) would provide useful information. In the PRA, for accounting purposes, the net open risk position(s) of dynamically managed portfolio(s) is identified and revalued for changes in the managed risk (for example, interest rate risk) with any gains/losses recognised in profit or loss.	19 September 2014	17 October 2014

FOR MORE INFORMATION

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