IFRS News
Emerging issues and practical guidance*

Issue 70 – January 2009

IASB marks year end with a flurry of activity

The IASB has issued two sets of proposed amendments to existing standards and an exposure draft on consolidation as a further response to current economic conditions. Both sets of amendments have very short comment periods. A discussion paper on revenue recognition – a convergence project – was also issued by both the IASB and the FASB in December. The proposals are summarised below.

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*connectedthinking

Proposed amendments to IFRS 7 – investments in debt instruments

Attendees of the global financial crisis roundtable meetings held jointly by the IASB and FASB in November and December 2008 suggested that disaggregated information about impairment losses on available-for-sale debt instruments would be useful. The IASB believes that extending the disclosures will allow users of financial statements to more easily compare investments in debt instruments.

The IASB has published an exposure draft on 23 December that will require additional disclosures in December 2008 financial statements for investments in debt instruments. Should the proposed amendments be finalised as drafted, entities will be required to disclose the following information in tabular format (without comparatives).

For all debt instruments (for example, loans and receivables, available for sale debt investments and held to maturity financial assets), other than those classified as at fair value through profit or loss:

	31 December 2008		
	Carrying amount	**Fair value**	**Amortised cost**
Loans and receivables	X	X	X
Held to maturity investments	X	X	X
Available for sale debt investments	X	X	X
Total	X	X	X

	31 December 2008 Pre-tax profit or loss in each scenario
If all investments in debt instruments had been classified at fair value through profit or loss	X
If all investments in debt instruments had been accounted for at amortised cost	X

Comments are due by 15 January 2009 and all concerned parties are encouraged to respond.

PRICEWATERHOUSECOOPERS

Proposed amendments to IFRIC 9 and IAS 39 – embedded derivatives

The IASB published an exposure draft on 22 December that will amend IFRIC 9 and IAS 39 in relation to embedded derivatives. The ED proposes a mandatory assessment of any embedded derivatives following reclassification of a financial asset out of the fair value through profit or loss category. The assessment will not have taken place at initial recognition, as the entire asset was accounted for at fair value.

The Board has explained that the amendment is necessary to ensure that, following a reclassification from the fair value category, entities apply the requirements for separation of an embedded derivative that is not closely related to the host contract. The assessment should be made on the basis of the circumstances that existed when the entity first became a party to the contract. In addition, if the fair value of the embedded derivative that would have to be separated cannot be reliably measured, the Board has proposed that the hybrid financial asset in its entirety should remain in the fair value through profit or loss category.

The ED has a proposed effective date for annual periods ending on or after 15 December 2008 with full retrospective application. If amendments are accepted as proposed, entities that used the October 2008 change to IAS 39 will need to apply this in their December 2008 financial statements.

Comments are due by 21 January and all concerned parties are encouraged to respond.

ED 10, 'Consolidated financial statements'

The IASB has published ED 10, 'Consolidated financial statements'. The exposure draft is expected to replace existing IAS 27 and SIC 12. It proposes a single control based model as the basis for consolidation and expands the disclosure requirements. The proposals are expected to result in little change in the scope of consolidation for operating companies but introduce a new term 'structured entity' and may have more impact on consolidation decisions for these entities.

The proposals form part of the Board's comprehensive review of off balance sheet activities and its response to the recommendations from the Financial Stability Forum, the international body tasked with co-ordinating the global regulatory response to the credit crisis. Further proposals, covering the derecognition of assets and liabilities, are due to be published in the first quarter of 2009.

Comments are due by 20 March 2009.

Discussion paper on revenue

The IASB has issued a discussion paper that proposes a change to the revenue recognition guidance. The DP (also issued by the FASB) will lead to a new, converged and comprehensive IFRS that will replace the present standards IAS 18, 'Revenue' and IAS 11, 'Construction contracts'. The objective of the joint project is to develop a single revenue model that can be applied consistently regardless of industry.

Applying the underlying principle proposed by the IASB and the FASB, a company would recognise revenue when it satisfies a performance obligation by transferring goods and services to a customer as contractually agreed. That principle is similar to many existing requirements, and the boards expect many transactions to remain unaffected by the proposals. However, the expectation is that that clarifying that principle and applying it consistently to all contracts with customers will improve the comparability and clarity of revenue for users of financial statements.

Comments are due by 19 June.

IFRIC guidance on distributions of non-cash assets to owners

Ago Vilu, partner in PwC's Accounting Consulting Services group in Central and Eastern Europe, explains the implications of IFRIC 17, 'Distributions of non-cash assets to owners'.

Transactions with shareholders has always been a grey area under IFRS and raised many application questions. The only guidance under IFRS was a paragraph in IAS 1, 'First-time adoption of IFRS', which required transactions with owners acting in their capacity as such to be reflected within equity. Diversity in practice developed as a result. The IFRIC responded to requests for guidance around demergers and other 'in specie' distributions by issuing IFRIC 17, 'Distributions of non-cash assets to owners', in November 2008.

Scope

The scope of IFRIC 17 is narrow and carefully defined, as follows:

- Transactions with owners are defined as falling into two broad categories: exchange transactions and non-reciprocal transfers. The latter are commonly referred to as contributions and distributions. Exchange transactions between an entity and its owners have not been addressed; this would encompass measurement of many related-party transactions, deemed to be a subject too broad for an interpretation. The interpretation also describes the diversity in practice as mainly around distributions of non-cash assets and distributions that give a choice of a non-cash asset or a cash alternative. The scope of IFRIC 17 is therefore limited to these types of distributions. A non-reciprocal transfer of a non-cash asset to owners will therefore be captured by the interpretation, whereas a 'sale' of the same asset to owners at a non-market price is not addressed.

- IFRIC 17 is limited to distributions where all owners are treated equally. This is because distributions in which owners of the same class of equity instrument are not all treated equally implied, in the IFRIC's view, that some owners receiving the distribution indeed gave up something to the entity and/or other owners; therefore, such distributions in substance represent exchange transactions.

- IFRIC 17 only applies to distributions that result in a change in control over assets distributed. This requirement effectively scopes out any distribution by an entity ultimately controlled by a single party or parties. This is because, in the IFRIC's view, distributions where the asset is ultimately controlled by the same party or parties both before and after the distribution are often made for the purpose of group restructuring rather than representing a genuine dividend payment. In addition, the IASB has added a common control transactions project to its agenda, so the IFRIC considered it appropriate not to cover common control distributions in the interpretation.

- The change-in-control requirement scopes out partial distributions of subsidiaries where control over the subsidiary is retained by the distributing entity. IFRIC 17 makes it clear that such distributions qualify as transactions with non-controlling shareholders and are accounted for under IAS 27.

Implications of the change-in-control requirement are illustrated below.

Example 1
Entity A is owned by public shareholders. No single shareholder (or group of shareholders bound together by a contractual arrangement) controls Entity A. Entity A distributes 100% of its interest in its wholly owned subsidiary, Entity B, to its shareholders. The transaction is within the scope of IFRIC 17.

Example 2
Entity C is owned by public shareholders. No single shareholder (or group of shareholders bound together by a contractual arrangement) controls Entity C. Entity C distributes some of its interest in its wholly owned subsidiary, Entity D, to its shareholders but retains a controlling interest in Entity D. The transaction is outside the scope of IFRIC 17.

Example 3
Entity E is owned by public shareholders. A group of shareholders bound together by a contractual arrangement controls entity E, and there are also other non-controlling shareholders. Entity E distributes 100% of its interest in its wholly owned subsidiary, Entity F, to its shareholders. The entire transaction – that is, both the distribution to the controlling shareholders and to the other shareholders – is outside the scope of IFRIC 17.

Recognition and measurement

IFRIC 17 clarifies that a dividend payable should be recognised when the dividend is appropriately authorised and is no longer

at the discretion of the entity. This date will differ by jurisdiction. For example, if the jurisdiction requires shareholders' approval, the liability is not recognised until such approval is granted. Where shareholders' approval is not required, the dividend payable is normally recognised when declared.

The dividend payable is recorded at the fair value of the net assets to be distributed. Where a choice of settlement is given, management considers fair values of both alternatives and their respective probabilities. Where the net assets distributed constitute a business, the liability is measured at the fair value of the business rather than the sum of individual fair values of the net assets constituting the business (ie, they include goodwill, identifiable intangible assets and contingent liabilities). The distribution liability is remeasured at fair value at each reporting date, with measurement adjustments taken to equity.

The IFRIC recognised that fair value of some distributions (for example, ownership interest in a non-traded entity) may not be readily available but did not provide any exemptions from the measurement principle. Management is expected to be able to measure the value of any distribution. In addition, dividend income is measured at fair value under IAS 18; thus the interpretation does not impose a more onerous requirement on the entity making the distribution as compared to the recipient of the distribution.

IFRIC 17 requires an entity making the distribution to recognise the difference between the carrying amount of the dividend payable and the carrying amount of the net assets distributed in profit or loss. This difference is presented as a separate line item. The difference will always be represented by a 'credit balance' because any decline in value of the assets distributed would have been captured by the impairment provisions of relevant IFRSs. IFRIC 17 thus effectively requires recognition of previously unrealised gains on non-cash assets distributed to owners.

The IFRIC specifically invited comments from constituents on profit or loss versus equity recognition and carefully considered the two alternative approaches. It recognises that under IAS 1, distributions to owners are recognised in equity. At the same time, it concluded that the difference in question does not arise from a distribution as such but represents a change in value of the asset to be distributed. Under IFRSs (for example, IAS 16, IAS 38, IAS 39 and IFRS 5), such changes are reflected in profit or loss when the asset is derecognised. In addition, the IFRIC noted that the profit or loss approach will have the same accounting effect as would have been achieved had an entity sold the asset and distributed cash to shareholders. It therefore agreed that profit or loss recognition will best reflect the economic substance of the transaction.

Consequential amendments to IFRS 5

Once an entity has committed to distribute assets to its owners, the carrying value of the assets will no longer be recovered through continuing use. IFRS 5 will therefore be amended to capture assets held for distribution. The amended IFRS 5 will require non-current assets held for distribution to be measured at the lower of their carrying amount and fair value less costs to distribute. IFRS 5 will apply at the 'commitment date' – that is, when the assets are available for immediate distribution in their present condition and the distribution is highly probable.

Effective date and transitional provisions

IFRIC 17 and consequential amendments to IFRS 5 apply for annual periods starting on or after 1 July 2009 (ie, 2010 for calendar-year entities). Earlier application is permitted. The IFRIC recognised potential difficulties around fair value measurement of the liability and therefore required prospective application of the interpretation.

Publisher's poetry corner

***IFRS News*' publisher, Mary Dolson, has spent the holiday period 'improving' on the Christmas classic 'The twelve days of Christmas'. May readers forgive some flexibility over the rhythm.**

On the twelfth day of Christmas my true love sent to me:
12 users modelling
11 preparers crunching
10 Board members leaping
9 accountants dancing
8 staff a-drafting
(IFRS) 7 new amendments
6 EDs for comment
5 golden rules
4 written puts
3 interpretations
2 impaired assets and
1 global standard setter.

US path to IFRS – looking ahead

Dave Kaplan, PwC's Leader of US International Accounting and SEC Services, looks at the SEC's proposed roadmap, the likely short-term implications and how US companies could prepare for IFRS.

With the November 2008 release of a proposed roadmap for allowing US domestic public companies to use IFRS, the US Securities & Exchange Commission (SEC) effectively ensured that the US path to IFRS will remain in the headlines throughout 2009. Comments on the proposed roadmap are due in mid-February, and the number of commentators is expected to exceed almost any other proposal released by the SEC. The comment letters will likely fuel the debate over whether and how the final roadmap should be implemented, leading right up to the issuance of the final roadmap, which is unlikely to occur until late 2009.

The SEC did not set a definitive date for moving the US to IFRS in the proposed roadmap. Rather, they established a number of milestones for moving to IFRS, and committed to revisiting in 2011 the question of mandatory IFRS adoption for the US. They will assess in 2011 whether sufficient progress has been made toward those milestones.

Some of the more significant milestones include:

- Achieving sufficient improvements to IFRS.
- Enhancing the independence, accountability and funding of the IASB and its Trustee Organisation.
- Achieving sufficient progress on the taxonomy for XBRL compatibility.
- Realising sufficient improvement in IFRS education and training in the US.

The SEC also plans to study the consistency with which IFRS is applied globally, believing that consistent application of IFRS as issued by the IASB is critical prior to moving the US to IFRS.

The proposed roadmap suggests that a reasonable timeline for moving the largest US public companies to IFRS is 2014, with mid-size and smaller public companies moving in 2015 and 2016, respectively. First-time adopters would be required to file three years of IFRS financial statements (two comparative years), consistent with current SEC requirements.

Included in the proposed roadmap is a proposed rule that would allow companies meeting certain eligibility criteria to adopt IFRS as early as 2009. To qualify, companies would have to be in industries where, globally, IFRS is used more than any other accounting framework. These companies would also have to fall within the largest 20 companies in their industry, as measured by market capitalisation, in order to qualify for early adoption. Finally, any eligible company wishing to adopt early would need to obtain a letter of no objection from the SEC.

Additionally, the SEC is asking respondents for views on two transition alternatives by filers that elect early IFRS adoption. First, filers would provide a one-time reconciliation of US GAAP to IFRS in accordance with normal IFRS 1 transition requirements. Under an alternative, filers would have to provide an annual unaudited supplemental reconciliation from IFRS to US GAAP covering the three-year filing period.

Implications of the proposed roadmap

In the absence of a firm decision to move forward with IFRS until at least 2011, the restrictive eligibility requirements and the potentially onerous reconciliation requirements for companies who decide to convert to IFRS early are likely to dissuade virtually all US companies from early adopting. Some US companies may even put the topic of IFRS on the back burner for now. However, strategic, forward-thinking companies are expected to continue planning for IFRS adoption.

Although the path ahead for IFRS in the US is not yet clearly defined, the end-game is virtually certain: all signs point to the eventual use of IFRS by US companies. To develop a thoughtful and strategic approach, companies should begin to learn more about IFRS and how it may impact them. Specifically, companies would benefit from performing a preliminary study now to identify business-, accounting-, investor-, systems-, controls- and workforce-related issues that could arise during an IFRS conversion. Companies should also identify key IFRS conversion considerations and incorporate them into business planning to ensure they are considered as a business changes occur over the next few years.

Management must prioritise the investment of resources and capital, especially in these difficult financial times. While a comprehensive IFRS transition programme may be farther off, there are certain areas of focus that can provide benefit now. Companies should consider the most significant IFRS conversion activities, as identified in a preliminary study, and make an investment only to the extent that company or industry-specific circumstances warrant it.

Multinational companies should also consider the impact of IFRS on foreign subsidiaries and understand where the company already uses IFRS or could use IFRS in the near

future, and ensure the US parent maintains control of IFRS decisions across the business.

The road ahead

Given the scrutiny around accounting and its role in the global credit crisis, it is not surprising that the SEC has chosen a cautious, measured approach to laying out the path forward for a US move to IFRS. However, the credit crisis also clearly demonstrates the interconnected nature of the global financial markets and further demonstrates the need for a single set of high-quality accounting standards.

A confluence of factors will influence the direction the SEC takes related to IFRS over the next 12 months – the development of new accounting standards by both the FASB and IASB, the political implications of a new US presidential administration, the comments received from constituents on the proposed roadmap, and even the level of vigour with which the EU continues to support the IASB, to name a few. Companies will need to stay tuned and monitor the timing and tenor of the developments in order to plan appropriately.

IFRS 3R and hedge accounting

The revised standard for business combinations (a joint project between the FASB and IASB) will be effective for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July 2009. Scott Bandura of PwC's Global ACS writes about the impact on hedge accounting now, as the new standard may have a significant effect on hedge accounting of acquired businesses.

IFRS 3 revised introduces an explicit requirement that all contracts of the acquired business need to be re-assessed. Among other impacts, this is expected to have the practical result that hedge accounting of the target will seldom survive a business combination. Below is a simple example that illustrates the difference between current IFRS 3 and IFRS 3 revised.

The acquirer acquires Target Co on 1 January 2010. Target Co has several interest rate swaps, which it is using to fix interest rates on its long-term liabilities. It has appropriately documented these interest rate swaps as cash flow hedging instruments. The interest rate swaps will expire in three years from 1 January 2010. The swaps are in an liability position of C1,500 at the date of acquisition.

IFRS 3 was silent, and as a practical matter the acquirer could make an accounting policy choice to continue the documented hedging relationships of acquired businesses.

Under IFRS 3R, an acquirer cannot assume the continuation of hedging relationships in the acquirer's group accounts. IFRS 3R requires the acquirer to designate hedging relationships 'on the basis of the pertinent conditions as they exist at the acquisition date'. The acquirer will therefore need to re-designate all of Target's hedging relationships if it wants to recognise those relationships in its group accounts.

Re-designation of hedging relationships on a business combination will give rise to a number of issues and these are explored below.

Practical issues

The swap is in a liability position of C1,500 at the date of acquisition. Designating derivatives with non-zero fair values leads to ineffectiveness. The ineffectiveness may be so great in some cases that the relationship would fail to qualify for hedge accounting altogether.

Net written options cannot generally be designated as a hedging instrument. Instead of using an interest rate swap, assume Target was using an interest rate collar, which was in a liability position of C1,500 at the date of acquisition. The acquirer would be precluded from designating the collar in a hedging relationship because collars in a liability position are considered net written options.

Hedging relationships need to be contemporaneously documented. The acquirer will therefore need to put in place hedging documentation for the relationships in its group accounts.

Practical implications for business combinations

The acquirer will need to understand the type of hedging that Target has done long before the actual acquisition date so that it can understand what new derivatives it may need to acquire and the contemporaneous documentation that it will need to put in place at the acquisition date.

The acquired business might close out its derivative instruments immediately prior to the acquisition date to avoid some of the pitfalls with non-zero fair value derivatives and the net written option test. This way, the acquirer could put in place new derivative instruments with a zero fair value on the acquisition date for the desired hedging relationships.

The acquirer has the flexibility to reclassify financial assets and liabilities of the acquired business on the acquisition date. The acquirer may choose, as an alternative to closing out Target's derivatives, to use the fair value option for certain hedged items. This would reduce mismatches in income as a result of re-measuring the derivative instrument at fair value each period.

Fair value: what's going on?

The credit crisis has stimulated a great deal of debate about fair value measurement of financial instruments. Peter Hogarth and Muriel Maisborn of PwC's Global Accounting Consulting Services in the UK look at the key questions and implications.

Is this just about banks?

Fair value measurement of financial instruments affects many companies, not just those in the financial services sector – for example, assets held in defined benefit pension schemes. Many will be concerned in the current climate about fair value measurement in an inactive market.

> **What is the PwC view on fair value measurement?**
>
> There has been much focus on the rights and wrongs of fair value measurement under current market conditions. We support fair value measurement of financial instruments where it is required. But we recognise that the credit crisis raises some important questions, not least around transparency and methodology (such as how to measure and present fair value in illiquid markets) that should be debated more widely.

Has fair value accounting been suspended?

No, the requirements for fair value measurement have not changed. The objective remains to arrive at a price at which an asset could be exchanged between willing parties in an unforced transaction. Depending on the circumstances, quoted prices and/or valuation techniques are used to measure fair value. Fair value continues to apply to available-for-sale financial assets and financial instruments at fair value through profit or loss.

However, the Board's October 2008 amendment to permit reclassification of financial assets in certain circumstances recognises that management's intentions may change when markets become illiquid, leading to a need to reassess the appropriate classification and measurement. Once a company moves away from an intention to trade, fair value may no longer remain the most appropriate measure; if financial instruments have not been reclassified, fair value measurement will remain necessary.

Which financial instruments can be reclassified?

The reclassification amendment is limited in its scope. Derivatives, financial liabilities and financial assets designated at fair value at inception under the fair value option cannot be reclassified. The only items affected by the amendment are financial assets that are either available for sale or held for trading. An available-for-sale asset may be reclassified to loans and receivables and measured at amortised cost if it would have met the definition of loans and receivables at the date of reclassification and the company intends to hold the asset for the foreseeable future or until maturity. An asset that is held for trading may be reclassified in similar circumstances or, additionally, in 'rare' circumstances. Assets that are reclassified under the October 2008 IAS 39 amendment cannot subsequently be reclassified back into the fair value through profit or loss category.

In the current climate, are all transactions 'distressed sales'?

No, the IASB formed an Expert Advisory Panel, which published a paper in October 2008 giving guidance on fair value measurement in inactive markets. That paper identifies the following indicators of a distressed transaction:

- A legal requirement to transact (such as where there is a regulatory mandate);
- A need to dispose of an asset immediately without sufficient time to market it and thereby achieve a reasonable price; or
- Only one potential buyer as a result of legal or time restrictions.

Transactions meeting the above criteria are not expected to be common, even under current market conditions.

If transactions are not distressed sales, the normal fair value measurement principles apply. Even in an inactive market, transaction prices are not ignored: the most recent transaction price should be considered as an input to the valuation model.

When can management use a model?

The method of valuation will not normally change from year to year. However, it may be necessary to use a valuation model if the market has become inactive and there is no current quoted price. Inputs to valuation models should reflect current market conditions, including actual liquidity and credit spreads. See the Expert Advisory Panel paper referred to above and the Board's November *IFRIC Update*.

What disclosures are required around fair value measurement?

The main disclosures required are:

- Fair value and certain changes in fair value for each class of financial instrument. [IFRS 7.25-30].
- Whether quoted prices in active market or a valuation technique have been used. [IFRS 7.27].
- The assumptions for valuation techniques and, in certain cases, sensitivity to alternative assumptions. [IAS 1.116 and 120 and IFRS 7.27].
- Any abnormally large change after the balance sheet date in asset prices or foreign exchange rates as part of post balance sheet events. [IAS 10.22(g)].

There are specific additional disclosure requirements for reclassifications from a category measured at fair value to a category measured at amortised costs. [IFRS7.12A].

Are any other changes to IFRS expected for December/March period ends?

The last few months have shown that it is very difficult to predict what may happen. That said, there are two items to be aware of:

- An exposure draft of amendments to IFRS 7, which proposes greater transparency around the determination of fair value for financial instruments. However, these are currently proposed to be mandatory only for periods beginning on or after 1 July 2009.
- The recent G20 summit proposed that the key global accounting standards bodies should work to enhance guidance for valuation of complex, illiquid products, especially during times of stress. In response, the Board has committed to issue an exposure draft on fair value measurement by the second quarter of 2009.

Fair value: a personal view

Leader of PwC's UK Accounting Consulting Services Peter Holgate gives his view of the recent debates on fair value accounting.

One of the many areas that have been scrutinised in the context of the credit crunch is the validity of, and role played by, fair value accounting – in particular, accounting for various financial instruments at fair value (although of course not all financial instruments are accounted for at fair value).

So many questions and challenges have been raised recently that it is easy to forget that the fair value requirements in IFRS remain in force. There is only one minor exception: the change to IAS 39 introduced in October 2008, which allows companies to reclassify certain assets out of 'fair value through profit and loss' into other categories. It is a small aspect of IAS 39 and applies in practice to very few companies (mainly banks) and in narrowly-defined circumstances

In another sense, though, it is a very significant change because of the particular arguments and events from which it stems. Some commentators argued that it should, in at least some contexts, be possible to opt out of fair value accounting. These points were put to a summit of the EU G8 heads of state in Paris on 4 October 2008, and this led to the IASB making an immediate change to its rules to allow reclassification of assets out of fair value through profit and loss.

It is comforting to know that accounting is so important that it secures the attention of presidents. Indeed, within a month, it gained the attention of more presidents and other heads of state. The G20 at their 'Summit on financial markets and the world economy' in Washington on 15 November 2008, called on the IASB and FASB to 'work to enhance guidance for valuation of securities, also taking into account the valuation of complex, illiquid products. …. [to] significantly advance their work to address weaknesses in accounting and disclosure standards for off-balance sheet vehicles … [and to] enhance the required disclosure of complex financial instruments …' and to do so by 31 March 2009. This call is more satisfactory for two reasons: it is from worldwide leaders, not just from the EU; and the subjects – valuation guidance, off balance sheet and disclosure – are more in keeping with what accountants generally would favour. They are aspects of accounting on which the IASB was already engaged, albeit at a speed that reflects its usual due process. Its Expert Advisory Panel had developed guidance on 'measuring and disclosing the fair value of financial instruments in markets that are no longer active'; and the IASB itself had projects underway on consolidations and derecognition, and on the reform of the disclosures required by IFRS 7.

> "Should fair value be based on exit value? How do we measure fair value in inactive markets? Should there be any widening of the recent permission to reclassify financial assets? To what extent should there be further harmonisation with US GAAP? Should the disclosures be enhanced? What disclosures about financial instruments entities give in interim reports?"

The standard setters and regulators are busy consulting publicly to form a response. The SEC held a roundtable on mark-to-market accounting on 21 November. The general consensus was that fair value accounting was not the root cause of the current market turmoil. The IASB and FASB have held 'global financial crisis roundtables' in London, New York and Tokyo. The IASB issued two further proposals in late December 2008 for comment by 21 January 2009. One exposure draft is a clarification of IFRIC 9, saying that embedded derivatives need to be re-assessed on any reclassification of assets (see p2). The other aspect is an additional disclosure requirement relating to available for sale debt investments. A further exposure draft on fair value measurement is likely in Q2 2009.

Overall, there appears to be general support for continuing with fair value accounting, but concern about the details. How exactly should fair value be defined? Should it be based on exit value, as in US GAAP? How do we measure fair value in inactive markets? The guidance from the IASB's Expert Advisory Panel is helpful but it does not and cannot make the problem go away. Should there be any widening of the recent permission to reclassify financial assets? To what extent should there be further harmonisation with US GAAP? Should the disclosures be enhanced as in the October proposals to amend IFRS 7? What disclosures about financial instruments should be given in interim reports?

There seems to be a broad consensus across preparers, users, auditors, politicians and regulators, and across most countries, that the IASB and the FASB should continue to work intensively on accounting for and disclosure of financial instruments. The Boards should be allowed to do their job independently. IAS 39 and fair valuing are not perfect but they are better than the alternative. They should therefore be retained and improved and not jettisoned. This, I think, is the right response. Dealing with complex matters at a time of almost unprecedented turmoil is bound to be difficult. Retreating with haste to the apparent comfort of historical cost would surely be a retrograde step.

The views in this article are Peter Holgate's own.

Readers have creative year in financial reporting haiku competition

***IFRS News*' haiku competition was a great success earlier this year. The winning entry, as selected by IASB member Tatsumi Yamada, was submitted by Kelley Wall of Rose Ryan. But we received a lot of entertaining entries, and take the opportunity at the end of the holiday season to share them with you below.**

Winner

Fair value sometimes
Clear day, historical cost
Mixed attribute fog
Kelley Wall, Rose Ryan

Runner-up

Dawn breaks
IASB Rejoices
worldwide harmony
Scott Bandura, PwC UK/US

Spring. Derivative
Bifurcated from its host
Free at last. Farewell!
Scott Bandura, PwC UK/US

Effective interest method
Cash flows vary
Sadness accrues
Scott Bandura, PwC UK/US

Credit-crunch crisis
Farewell to fair value
Faded in the mist
Alina Shaposhnik, PwC Israel

QSPE says
No consolidation, but
Change is coming soon
Yvonne Monyei, PwC US

Standards now are there
Preparer, don't despair
Principles are fair
Lars Jacobsson, Ericsson

Markets in turmoil
Impairment plentiful but…
plenty to reflect
Brendan van der Hoek, LloydsTSB

Recycle paper, plastic, glass
Is harmony. But,
Recycle from OCI to P&L is discord.
'Nichiren'

Even the gains
When out of control
Can turn into pain
Enrique Rosado

AFS reserve
(Non)-monetary item
IFRS suck
Oliver Kuster, Avaloq

On IAS 12
Between book and tax
Temporary differences
Look for number twelve
Roelf Kloen, PwC the Netherlands

New bus combs is here
Begin to talk to clients
Their earnings will change
Michael Gaull, PwC UK

Financial turmoil
A sign of the fall
Does it show true reflections
Despite endless waves?
'ookubo23768', Nissay, Japan

Phase II
The summer has passed
Don't regret but reflect the past
Build blocks for future
'ookubo23768', Nissay, Japan

Weird world becomes one
principles- based new standard
all will have impact
Renee Nikolai, PwC US

Drop pages of rules
and struggle with principles
For global success!
Crystal Reichwein, PNC

Business in winter
Of life. Discontinued when
Closed or to be sold
Clare de Arostegui, PwC UK

Head hurts looking at
Financial instruments. Cut
down complexity
Clare de Arostegui, PwC UK

Money cathedrals
Falling like leaves; Fair value
Cause and solution.
Wee Liam Foo, PwC Australia

Tons of transactions
Along the complexity
An error appears
Louis Vincent, Givaudan

A withered Rose bush
Leaves slumped under morning dew
The Bee waits for bloom
Matthew YL Kwong, PwC HK

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Beginners' guide: nine steps to income tax accounting

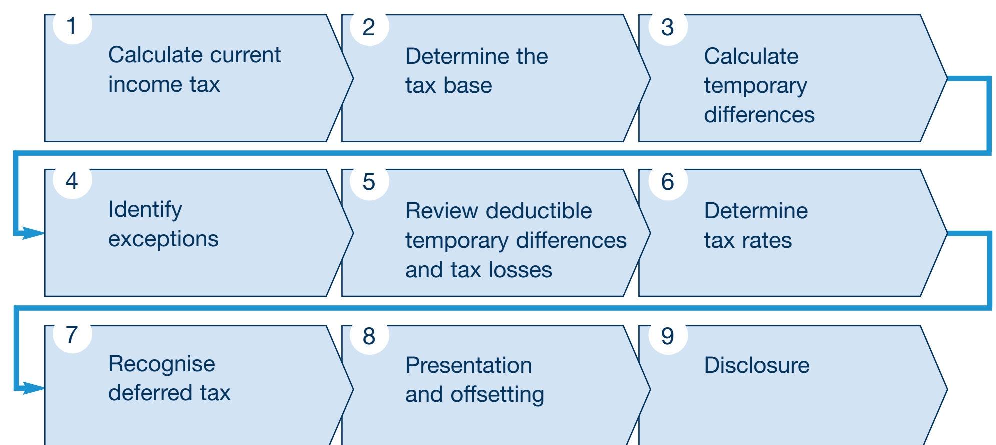
Deferred tax is not the most glamorous of accounting topics, but there is more to it than meets the eye. Bill Maloney of PwC's Global Accounting Consulting Services central team explains the logic behind deferred tax accounting and a nine-step approach to making it work[1].

Profit for accounting purposes and profit for tax purposes are seldom the same number, even in the most simple of companies. The book value of an asset or liability is often different from the amount assigned to that asset or liability for tax purposes; or they impact the income statement at different times. Think of deferred tax accounting as constructing a balance sheet based on IFRS and a corresponding tax balance sheet based on tax laws. The difference between the two balance sheets, measured at the right tax rate, means that the accounting profit or loss in any period may be different from the taxable profit or loss in the same period.

A company may end up paying tax when it recovers (for example, uses or sells) an asset or settles (for example, pays or transfers to a third party) a liability for its book (carrying) amount and there is no accounting profit or loss. Deferred tax accounting is designed to deal with this situation; management recognises deferred taxes based on these differences.

This beginner's guide sets out a simple nine-step approach to calculating deferred tax. Armed only with this methodology and the tax code, we hope to shed light on what can be the most opaque of assets or liabilities in the balance sheet.

Nine-step approach to calculating deferred tax



[1] Publishers note: there were so many potential puns and jokes in this beginners' guide that we had to do the only safe thing and leave them all out for fear of confusing the readers. So, we will pass silently over 12-step programmes, those who develop expertise in deferred tax and those of us who, while enlightened by this beginners' guide, now know more than we wanted to.

Let's use a fictional company, Widget Ltd, to illustrate the nine-step process. Widget began operations on 1 January 2008. Its book and tax financial statements are consistent except for two items explained below:

- Widget purchased a piece of equipment on 1 January 2008 for C200. The equipment has a useful life of four years and is depreciated on a straight-line basis (that is, evenly over the period) in the book balance sheet. The tax authority allows Widget to claim tax deductions for the cost of the equipment over two years, also on a straight-line basis.
- Widget records a warranty provision on its book balance sheet when revenue is recognised. The tax authority does not allow a deduction for the warranty expense until cash is paid to settle a warranty claim.

The tax rate in Widget's jurisdiction is 40%.

Step one: Calculate current income tax

Income tax expense is comprised of two parts: current tax and deferred tax. The first step is to calculate current tax by determining taxable profit for the period and multiplying that profit by the applicable tax rate. Widget Ltd recognises C1,000 of revenue for both book and tax purposes during the first year of operations. It also records book depreciation of C50 (C200/4) and warranty expense of C120. It does not pay any cash to settle warranty claims. Widget's book profit before considering income tax expense is C830. Widget claims a tax deduction of C100 for depreciation. Widget's taxable profit as shown on the tax return is C900.

	Book f/s	Tax f/s
Revenue	1,000	1,000
Depreciation	-50	-100
Warranty	-120	0
Income before tax expense	830	900

Applying a tax rate of 40% to the taxable profit results in current income tax expense of C360.

Step two: Determine the tax base

The next step is to build the tax balance sheet. A tax value or 'tax base' is assigned to each asset and liability on the accounting balance sheet. There may also be items on the tax balance sheet that do appear in the accounting balance sheet. The tax base reflects the tax consequences that will occur when the carrying amount of an asset or liability is recovered or settled – how much will be deducted for tax purposes when the asset is sold or the liability is paid? Understanding what will happen for tax purposes when the asset is sold or otherwise 'used up', or when the liability is settled, is critical to determining the tax base. For example, if management expects to recover the carrying value of a piece of equipment by using the equipment, the tax base is the expected tax deduction for the depreciation of that asset. If management expects to recover the carrying value by selling the equipment, the tax base is the expected tax deduction when the asset is sold.

The tax base of Widget's equipment is C200 when it is purchased because the tax authority will provide a deduction for the cost of the equipment. After the first year, the tax base is equal to the remaining unused deduction, or C100. The tax balance sheet does not include a liability for warranty costs because they are only deductible when the cash is paid. The tax base of the warranty provision is therefore nil.

Step 3: Calculate temporary differences

This step is simple. Compare the carrying value of each asset or liability to the corresponding tax base and calculate the difference. A temporary difference is 'taxable' if it results in the payment of additional tax; it is 'deductible' if it results in an additional tax deduction. Temporary differences arise as follows:

	Deductible temporary difference (deferred tax asset)	Taxable temporary difference (deferred tax liability)
Assets	Tax base > carrying amount	Carrying amount > tax base
Liabilities	Carrying amount > tax base	Tax base > carrying amount

Widget Ltd has a taxable temporary difference of C50 for the equipment (book carrying amount of C150 is greater than the tax basis of C100). Widget also has a deductible temporary difference of C120 for the warranty provision (book carrying amount of C120 is greater than the tax base of nil).

	Equipment	Warranty
Book carrying amount	150	120
Tax base	100	0
Deductible temporary difference	N/A	120
Taxable temporary difference	50	N/A

At the end of the second year (31 December 2009), the taxable temporary difference on the equipment will increase to C100 because Widget will record an additional C50 of book depreciation, and the new carrying amount will be C100. Widget will claim an additional C100 of tax depreciation, and the tax base will be nil. During the third and fourth years, the taxable temporary difference will reverse. Widget will continue to record book depreciation of C50 each year to lower the book carrying amount, but it will no longer receive any tax deductions for the equipment and will pay more tax as a result. The deductible temporary difference of C120 for the warranty provision will reverse when cash is paid to settle warranty claims. The cash payment is deductible for tax purposes when paid.

Step 4: Identify exceptions

Deferred tax is recognised for all temporary differences, subject to three exceptions as described in the following paragraphs.

Initial recognition of an asset or liability
Deferred tax is not recognised when an entity acquires an asset or liability outside a business combination and in a transaction that does not affect accounting profit or taxable profit. For example, if a company acquires an asset for C100 and the tax authority provides a deduction of only C60, a taxable temporary difference C40 exists. Recording a deferred tax liability would increase the carrying amount of the asset, which would increase the temporary difference and require an additional deferred tax liability. The resulting calculation results in a gross-up of the asset and the deferred tax liability. This gross-up is seen as making the financial statements less transparent. Entities are not permitted to recognise deferred taxes in this situation.

Non-deductible goodwill arising in a business combination
Goodwill is a residual amount, and recognising a deferred tax liability would increase goodwill, which in turn would impact the temporary difference. Again, the iterative calculation would gross up goodwill and the deferred tax liability, and IAS 12 does not permit recognition of the deferred tax liability.

Investments in subsidiaries and associates
The carrying amount of an investment in a subsidiary or associate may differ from the tax base. This difference may arise for a number of reasons, including unremitted earnings, currency translation adjustments, or unrealised gains and losses on available-for-sale securities held by the subsidiary or associate. Deferred taxes have to be recognised for any temporary difference associated with investments in subsidiaries and associates unless the investor is able to control the timing of the reversal and it is probable that the temporary difference will not reverse in the foreseeable future.

Widget is not subject to any of these exceptions.

Step 5: Review deductible temporary differences and tax losses

Deferred tax liabilities are always recognised for taxable temporary differences, subject to the exceptions described above. Widget should therefore recognise a deferred tax liability associated with its equipment. Deductible temporary differences, however, should be recognised as deferred tax assets only to the extent it is probable that future taxable profits will be available against which the deductible temporary difference can be used. Future taxable profits arise from three main sources as described below.

Taxable temporary differences
An entity should first consider the reversal of existing taxable temporary differences. Taxable profits will increase when these temporary differences reverse, and if they are expected to reverse in the same period as the deductible temporary differences, relate to the same taxation authority and will provide the appropriate type of income (for example, ordinary versus capital), the related deferred tax asset should be recognised.

Future trading profits
Second, an entity should consider whether its ongoing operations will generate sufficient taxable profits (exclusive of the reversing taxable temporary differences) to utilise deductible temporary differences. This analysis requires careful consideration, particularly when an entity has a recent history of losses. What caused the recent losses? What are the budgets and forecasts? How reliable have those budgets and forecasts been in the past? Why type of product is being sold and in what industry? When do the tax losses and tax credits expire? Answers to these questions will determine whether an entity can rely on expected future taxable profits.

Tax planning opportunities
The third source of future taxable profit comes from tax planning opportunities. Tax planning opportunities are actions an entity would not normally take but would take to realise a deferred tax asset. For example, an entity may take some action to accelerate taxable income to an earlier period to ensure a tax loss does not expire.

Widget Ltd is able recognise at least C50 of the C120 deductible temporary difference related to the warranty provision because of the C50 taxable temporary difference related to the equipment. The recognition of the remaining deductible temporary difference depends on whether other sources of future taxable profits are available. For purposes of this example, assume Widget expects to make sufficient profits in the future from ongoing operations and is therefore able to recognise the entire deferred tax asset.

Step 6: Determine tax rates

The recovery of an asset or the settlement of a liability may not occur for many years. Deferred taxes should be measured at the tax rates that are expected to apply when an asset is realised or a liability is settled. Deferred tax is calculated using the rate that has been ‘enacted or substantively enacted’ by the end of the reporting period. In our example, the existing tax rate for Widget Ltd is 40%. If a change in tax law has been substantively enacted at the balance sheet date that will reduce the existing tax rate to 30% in 2011, temporary differences that reverse in 2009 and 2010 should be measured at 40% and temporary difference that reverse in 2011 should be measured at 30%.

Step 7: Recognise deferred tax

Multiply the temporary differences by the applicable tax rate and recognise the deferred tax in a manner consistent with the pre-

tax accounting. In other words, current and deferred tax should be recognised in the income statement unless the tax relates to an item that was recorded outside of the income statement (for example, in equity).

Widget will record a deferred tax liability of C20 (C50 * 40%) and a deferred tax asset of C48 (C120 * 40%) at the end the first year. The deferred tax expense of C20 and the deferred tax benefit of C48 will be recorded in the income statement. The current tax charge of C360 (Step 1 above) is offset by the net deferred tax benefit of C28 (C48 less C20), and the total income tax expense in the IFRS financial statements is C332.

The final income statement result for Widget's first year of operations is as follows:

	Book
Revenue	1,000
Depreciation	-50
Warranty	-100
Income before tax	830
Income tax expense	-332
Net income	498

Notice that Widget's effective tax rate (that is, income tax expense divided by income before tax) is 40% (C332/C830), which is consistent with the tax rate in Widget's tax jurisdiction. If only current tax had been considered, the effective tax rate would have been 43% (C360/C830). The deferred tax benefit of C28 has the effect of 'normalising' the effective tax rate. Widget also has a deferred tax asset on its balance sheet to account for the future tax consequences of settling the warranty provision and a deferred tax liability to account for the future tax consequences of recovering the carrying amount of the equipment.

Step 8: Presentation and offsetting

Current tax assets and liabilities can be offset and deferred tax assets and liabilities can be offset if an entity has a legally enforceable right to set off the amounts and intends to either settle them on a net basis or realise the asset and liability simultaneously. Practically speaking, offsetting can be done when the taxes relate to the same tax jurisdiction and the taxing jurisdiction permits net payment.

Deferred tax assets and deferred tax liabilities should always be presented as non-current in the balance sheet.

Widget will present a net deferred tax asset of C28 (gross deferred tax asset of C48 less gross deferred tax liability of C20) in its IFRS balance sheet at 31 December 2008.

Step 9: Disclosure

Transparency around income tax accounting is critical. IAS 12 contains a number of disclosure requirements. Two of the more important, and often overlooked, requirements relate to deferred tax assets and deferred tax liabilities that have not been recognised. The first of these is for tax losses that are carried forward. If a deferred tax asset has not been recognised for these tax losses because it is not probable that future taxable profits will be available (See Step 5), the amount of the losses and the expiry date should be disclosed. The second disclosure is for temporary differences associated with investments in subsidiaries and associates. If a deferred tax liability has not been recognised because the company asserts it meets the criteria for the exception described in Step 4, the unrecognised amount should be disclosed. Companies should also consider including the accounting for income taxes in their critical estimates and judgements.

Does income tax accounting get more complicated than this? Not really. The fact patterns may be cryptic and the accounting guidance may seem complex, but sticking to these nine steps will keep you on the straight and narrow path to success.