IFRS news

Emerging issues and practical guidance*

Issue 76 – July/August 2009

IASB publishes first of the financial instruments exposure drafts

The IASB issued the exposure draft 'Financial instruments: Classification and measurement' in July as phase 1 of its accelerated project to replace IAS 39 in accounting for financial instruments. The exposure draft forms part of the IASB's response to the global financial crisis and is consistent with the recommendations made by the G20. Jessica Taurae in the Global Accounting Consulting Services central team looks at the detail.

IAS 39 has been criticised for being difficult to apply and interpret and for exacerbating the current economic crisis. The G20, Financial Stability Board, Financial Crisis Advisory Group and others have urged the IASB to develop a comprehensive standard that will address key issues arising from the financial crisis.

This exposure draft is the first of three that will replace IAS 39. The second exposure draft will address impairment methodology (expected in October 2009); the third will address how to improve and simplify hedge accounting (expected in December 2009). The complete package with the derecognition exposure draft will replace IAS 39 in 2010.

The ED proposes to reduce the many financial instrument classification and measurement categories and their associated impairment models in IAS 39 to two.

The proposals

The ED proposes two measurement categories: amortised cost and fair value (see flowchart on p2). Debt or equity classification is the first question management will need to consider.

Debt instruments

If an instrument is debt, companies will need to consider whether the financial asset or liability has basic loan features and is managed on a contractual yield basis (see box on p3). If yes, the instrument is eligible for amortised cost measurement. Companies will have the ability to designate that instrument as at fair value through profit or loss if it reduces or eliminates an accounting mismatch. If the debt instrument does not have basic loan features or is not managed on a contractual-yield basis, the instrument is measured at fair value through profit or loss. The proposals remove the held-to-maturity category and its tainting rules. Reclassifications between amortised cost and fair value are prohibited.

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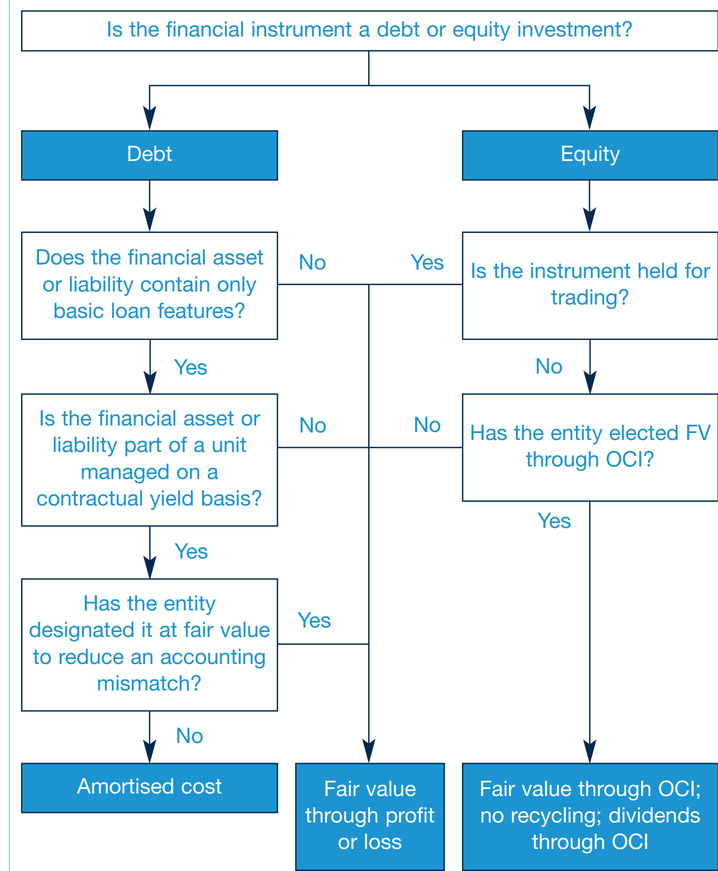
Amortised cost versus fair value measurement



Equity instruments

Investments in equity instruments are always measured at fair value. Equity instruments that are held for trading are required to be classified as fair value through profit or loss. For all other equities, management has the ability to make an irrevocable election to present changes in fair value in OCI rather than profit or loss. This treatment would apply for all fair value changes as well as dividends. There would be no recycling of amounts from OCI to profit and loss, nor would there be any impairment requirements. The proposals also remove the exemption to measure unquoted equity investments at cost when fair value cannot be determined reliably.

Embedded derivatives

The proposals remove the requirement to consider whether a financial instrument contains non-closely related embedded derivatives that require separation. The classification approach proposed in the exposure draft would assess whether the entire instrument contains only basic loan features including its embedded derivatives. Not all closely related embedded derivatives under the existing IAS 39 requirements today would necessarily be considered a basic loan feature under the proposals. The accounting for embedded derivatives in non-financial host contracts remains unchanged at this time.

Transition and effective date

The IASB is proposing that these amendments are applied retrospectively with some exceptions to provide relief. For example, if it is impracticable to retrospectively apply the effective interest method or impairment requirements, the fair value of the financial instrument at the date of initial application is deemed the amortised cost of the instrument for subsequent measurement.

The proposed changes if approved by the IASB may be voluntarily adopted by entities in their December 2009 financial statements. However, the changes are not expected to be mandatory until January 2012. If an entity adopts the proposal early, additional disclosures are required.

Possible implications

More financial instruments may be measured at fair value than currently, although that will largely depend on the financial instruments the entity holds or issues. Many government bonds and plain vanilla corporate bonds would be considered to have basic loan features.

Below are some examples of how the proposed requirements might be applied.

What are not basic loan features?

- All asset-backed securities that are not the most senior tranche of the structure will be required to be measured at fair value through profit or loss, as they are seen as providing credit protection to other tranches and therefore do not have basic loan features.
- All synthetic collateralised debt obligations will be required to be measured at fair value through profit or loss, as they contain contractual terms that change the timing or amount of payments of principal or interest and do not protect the investor but rather provide more risk to the investor.
- Most corporate-issued debt where an embedded derivative is currently separated and fair valued (including convertible bonds) will need to be measured in its entirety at fair value through profit or loss including changes in own credit risk, as the embedded derivative would not be considered a basic loan feature.
- All financial assets that are acquired at a discount that reflects incurred credit loses do not have basic loan features according to the proposals in the exposure draft. So where financial institutions have acquired such loans

from other financial institutions, the proposals would require those loans to be measured at fair value through profit or loss.

Managed on a contractual-yield basis?

It is not clear whether instruments that are part of a liquidity portfolio will be required to be measured at fair value through profit or loss under the proposals. For example, an entity may hold a financial instrument to realise contractual interest and principal payments until the entity needs to fulfil an obligation, at which time it will sell the asset (for example, assets held by insurance companies). The possibility that the entity may need to sell the asset may imply that it is not managed on a contractual-yield basis.

Next steps and co-ordination with FASB

Comments are due at the IASB by 14 September. The IASB and FASB are committed to working together to develop a comprehensive standard to improve the reporting of financial instruments. The FASB is still developing its proposals and expects to issue an exposure draft within the next few months. The IASB will expose for comment the FASB proposals if they are materially different from the IASB proposals. It is expected that the Boards will deliberate the responses to their respective exposure drafts jointly.

Significant changes are being proposed. Companies are encouraged to get engaged with this exposure draft and constructively respond to the IASB's proposals.

ED 'Financial instruments: Classifications and measurement' – at a glance

- The exposure draft proposes two measurement categories: amortised cost and fair value.
- For debt instruments, only those financial assets and liabilities that have basic loan features and are managed on a contractual-yield basis are eligible for amortised cost. A fair value option for reducing an accounting mismatch is also retained.
- All other debt instruments are to be measured at fair value through profit or loss.
- All equity investments are to be measured at fair value through profit or loss unless at initial recognition the entity elected to present changes in fair value through OCI and they are not held for trading.
- The exposure draft removes the requirement to assess a financial instrument for embedded derivatives.
- The exposure draft removes the exemption to hold unquoted equity investments at cost.
- Comments are due by 14 September.

Basic loan features

Basic loan features are defined as contractual terms that give rise on specified dates to cash flows that are payments of principal and interest on the principal outstanding. The exposure draft provides some examples of basic loan features:

- Fixed return over the life of the instrument.
- Variable return equal to a single quoted or observable interest rate (such as LIBOR).
- Combination of fixed and variable return (such as LIBOR + 50 basis points).
- Embedded caps, floors, collars.
- Pre-payment options where the pre-payment amount substantially represents unpaid amounts of principal and interest.

Managed on a contractual yield basis

Financial instruments are managed on a contractual-yield basis only if they are managed and their performance evaluated by the entity's key management personnel on the basis of the contractual cash flows that are generated when held or issued. The exposure draft provides the following examples of managed on a contractual yield basis:

- Trade accounts receivables (or payables) that an entity holds to collect (or pay) the cash amounts due.
- Instruments that an entity manages on the basis of contractual payments of principal and interest.
- Issued bonds that the entity manages on the basis of contractual interest and principal that it pays to investors under the terms of the contract.

IFRS in brief – twice-monthly overview of IFRS hot issues in practice

Want a snapshot view of the latest IFRS developments? Keep up to date with IFRS hot issues by subscribing to *IFRS in brief*. This twice-monthly financial reporting newsletter provides high-level guidance on current accounting issues that may have a significant impact on your balance sheet, disclosure obligations and/or communication with stakeholders.

IFRS in brief covers two topics in every issue, with each topic getting a page of coverage. It brings you the global insight and experience of PricewaterhouseCoopers' IFRS specialists and answers the questions: What is the issue? Am I affected? What do I need to do?

Click here to view the latest edition of *IFRS in brief*. Click here to receive *IFRS in brief* by email twice a month, or email ifrs.communications@au.pwc.com.

Cannon Street Press

EU endorsement

The European Union endorsed the following standards in June:

- IFRS 3 (revised), 'Business combinations', and the amendments to IAS 27, 'Consolidated and separate financial statements'. Both have an effective date for annual periods beginning on or after 1 July 2009; earlier adoption is permitted.
- IFRIC 16, 'Hedges of a net investment in a foreign operation'. It is applicable for accounting periods starting on or after 1 October 2008 and should be applied by EU entities for accounting period starting after 30 June 2009.

Final standard: IFRS for small and medium-sized entities

The Board published the 'IFRS for small and medium-sized entities' in July. It is a self-contained standard of around 230 pages, tailored to the needs and capabilities of smaller businesses. Many of the principles of full IFRS for recognising and measuring assets, liabilities, income and expense have been simplified. The number of required disclosures have also been simplified and reduced. There is no requirement to refer to full IFRS if a topic is not covered in the IFRS for SMEs. The IFRS for SMEs will be updated approximately every three years and re-issued as a complete volume.

The IASB estimates that SMEs as defined in this standard represent about 95% of companies worldwide. Immediate adoption is permitted, although it will be up to individual countries to permit, require or prohibit its adoption locally.

PricewaterhouseCoopers is publishing the following materials on the IFRS for SMEs:

- 'IFRS for SMEs – pocket guide 2009'. Now available on pwc.com/ifrs
- 'Similarities and differences – a comparison of 'full' IFRS and IFRS for SMEs'. Available in late August.
- 'IFRS for SMEs – Illustrative financial statements 2009'. Available in September.
- 'IFRS for SMEs – disclosure checklist 2009'. Available in Q4.

Final standard: IFRS 2 amendments

The Board has published amendments to IFRS 2, 'Share-based payment – group cash-settled share-based payment transactions'. The requirements will impact entities that receive goods or services in exchange for cash-settled share-based payments where the payments are made by another entity in the group.

These entities recognise in their separate financial statements an expense for those goods or services, regardless of which entity in the group settles the transaction or how the transaction is settled (that is, in shares or cash). The other side of the entry is an adjustment to equity, reflecting an equity contribution from the parent entity.

Subsidiaries that elect not to recognise an expense in their financial statements will need to change their accounting policy to reflect the amendments for annual reporting periods beginning on or after 1 January 2010. The new rules apply retrospectively, which means that affected entities will need to determine an adjustment to their opening retained earnings.

The amendment incorporates into IFRS 2 the guidance in IFRIC 8, 'Scope of IFRS 2', and IFRIC 11, 'IFRS 2 – Group and treasury share transactions'. IFRIC 8 and IFRIC 11 have therefore been withdrawn. The amended guidance in respect of group cash-settled share-based payment transactions will be effective for periods beginning on or after 1 January 2010.

Final standard: IFRS 1 amendments

The Board has issued amendments to IFRS 1, 'First-time Adoption of IFRS'. These address the retrospective application of IFRSs to particular situations and aim to ensure that entities applying IFRSs do not face undue cost or effort in the transition process.

The amendments exempt entities using the full cost method from retrospective application of IFRSs for oil and gas assets. They also exempt entities with existing leasing contracts from reassessing the classification of those contracts in accordance with IFRIC 4, 'Determining whether an arrangement contains a lease', when the application of local accounting requirements produced the same result. The amendments are effective for accounting periods beginning on or after 1 January 2010; earlier application is permitted.

Proposed changes to accounting for rate-regulated activities

The Board has published an exposure draft relating to the accounting for rate-regulated activities. Rate regulation is usually imposed by regulatory bodies or governments to restrict the prices that can be charged to customers for services or products.

The proposals aim to establish how assets and liabilities resulting from rate-regulated activities should be recognised and measured under IFRS. There is currently no guidance in this area. If adopted, the IASB's proposals will:

- Define regulatory assets and regulatory liabilities.
- Set out criteria for their recognition.
- Specify how they should be measured.
- Require disclosures about their financial effects.

The deadline for comments is 20 November 2009.

Cannon Street Press *continued*

Discussion paper: credit risk in liability measurement

The Board has published a discussion paper on the question of whether entities should factor in changes in their own credit risk to their liability measurements. The discussion paper was issued in response to concerns about recognising gains resulting from reductions in the fair value of an entity's liabilities due to the impact of the entity's 'own credit risk' (that is, the likelihood that the entity would default on payment of the liability).

It sets out reasons for and against including credit risk in the fair value measurement of liabilities and also provides some possible alternative accounting treatments.

The requirements will impact all entities that fair value their liabilities. For example, banks and other financial institutions commonly include their credit risk when remeasuring the fair value of certain liabilities. It will also impact entities that have derivatives in a liability position (for example, interest rate swaps).

The comment deadline is 1 September 2009.

Request for feedback: feasibility of expected loss model for impairment testing

The Board has requested feedback by next month on the practical issues that might arise if an expected loss model for the impairment of financial assets was introduced.

The model would affect all entities with financial assets that are classified as held to maturity or loans and receivables. Entities with listed equity securities would not be affected; these financial assets would still need to be tested for impairment using market prices.

The current model – the 'incurred loss model' – requires management to account for credit losses in financial assets only if events (such as financial difficulties of the borrower) have already occurred that have a negative effect on future cash flows. Management cannot consider the effects of future expected losses, no matter how likely they are to occur. Possible or expected future trends that may lead to a loss in the future (such as an expectation that unemployment will rise or a recession will occur) are also not taken into account.

The expected loss model requires management to make an assessment of expected credit losses on initial recognition of an asset and for this to be continually assessed. There is earlier recognition of credit losses under this approach compared to the incurred loss model. Some observers believe this would better reflect the way that financial assets are priced and the way that some companies manage their business.

Proposed non-mandatory guidance: management commentary

The Board has issued proposed non-mandatory guidance to help entities prepare and present a narrative report, often referred to as 'management commentary'. This is the information that many entities choose to provide users of their financial statements to show how their business's financial position, financial performance and cash flows relate to management's objectives and its strategies for achieving those objectives.

All entities that currently provide management commentary in their financial statements will be affected. Unlisted entities will be particularly affected because they do not currently have any guidance on what to include in their management commentaries.

The guidance will help entities prepare management commentaries that meet the needs of investors and other users of their financial statements. The Board also hopes the proposed non-mandatory guidance will improve the consistency and comparability of management commentary across entities around the world that apply IFRS.

The comment deadline is 1 March 2010.

Sudokhu

Level: challenging

			5				9	
		7			8	2	4	
2		3		4				
8		6					1	
3				8	2	5		
				1				9
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6		8	4	9			2	7
						9		

Find the solution on p7

How times have changed: financial reporting in the last 30 years

Global Accounting Consulting Services partner in the UK, Peter Holgate, takes a stroll down memory lane and looks at changes in financial reporting and the business environment over the last 30 years.

Young though I am[1], I was indeed a member of the working population 30 years ago. At the time, I practised (literally) UK GAAP. I have the UK GAAP bound volume for 1977, in a charming shade of turquoise – a slim volume of some 263 pages that includes 11 accounting standards (SSAPs). I still refer to it occasionally. I think it still applies.

The UK GAAP book also included an exposure draft (ED 18), which was the first proposal on 'current cost accounting'. There was high inflation at the time, and it was thought that adjustments needed to be made to reflect the effect of specific price changes, mainly of what we now call PPE and inventory (no one thought much about fair value accounting for financial instruments). This ED became a standard in 1980 and was so unpopular that it led to a revolt by the members of the Institute of Chartered Accountants of England and Wales. These were exciting times. The standard had to be withdrawn, and the whole debacle was the beginning of the end of standard-setting by the professional bodies. In 1990, an independent standard-setter (the UK ASB) was formed.

In the late 1970s, we had (just) heard of international accounting standards – the IASC had been formed in 1973 – but they were seen as something mainly for developing countries and nothing much to do with us. The capital markets focus that we now see was to emerge 10 or 20 years later. The IASC board was made up entirely of part-time volunteer members with a secretariat of four – see box for more details. The IASC was still such a slim operation even some years later (1986), that when I joined a predecessor firm after five years at the UK standard-setter, I was given a job of great responsibility by our deputy senior partner, who was a member of the IASC's board. The whole board and the whole secretariat were abroad for a week at a board meeting. It was my job to open up the IASC's offices every day, check the post and the answer-phone, and water the plants. The IASC's standard on agriculture followed a mere 15 years later.

The bound volume of IASs was also a slim book. I still have, and cherish as a historical document, the IASC's 1981 bound volume of IASs (it goes up to IAS 13, 'Presentation of current assets and current liabilities'). It is 154 pages long. This includes the first (1979) version of IAS 12, which was the international standard on deferred tax – an answer that is probably no better or worse than the ones we are using and debating now. The difference is that it is only 14 pages long. My main observation is that, after 30 years' experience, we are able to write an equally unsatisfactory document with much greater length and obscurity.

The most notable difference from today was that you could do whatever seemed sensible. Standards were beginning to narrow down the options in accounting but only in a limited way, and many choices remained. It is of course important to understand that this gave rise to the opportunity to exercise professional judgement; this is quite different from its being a 'free for all' in which anything goes. Professional judgement of the day included such skilled techniques as:

- Treating all leases as operating leases.
- Ignoring share-based payments completely[2].
- Ignoring derivatives[3].
- Revaluing assets on a random basis.
- Pretending that a 30-year-old tree was worth the same as a three-year-old tree.
- Providing for a wide range of future expenses, especially future reorganisation costs[4].

To be fair to the practitioners of the day, much of that seemingly lax regime can be explained by the fact that business was much simpler. Perhaps share-based payment awards were granted to employees but, if so, it was on a small scale. The whole area of derivatives was a tiny fraction of today's activity.

Also, 'the public interest' was not so well developed. There was therefore little focus on management commentary and virtually no concept of environmental and social reporting. Similarly, there was a much less transparent (or less intrusive) regime relating to the disclosure of directors' emoluments and related parties generally (the IAS appeared in 1984). Analysts, for their part, were less organised, less vocal and less well served by accounting. The standard on segment reporting appeared in 1982, but more comprehensive information on, say, detailed analysis of debt, had to wait until IAS 32 was published in 1995.

Life, then, was simple. Unlike today, politicians were not involved in accounting. This is because, unlike today's more

1 Clearly an error in drafting the article, but not corrected through kindness - Ed.
2 Not that there were many, to be fair, except share-for-share acquisitions, which we did account for, though not very well.
3 Not that there were many. At least, we didn't find many; and those that we found were generally not well understood.
4 Especially in profitable years.

10 features of standard-setting 30 years ago

1. No IASC Framework
2. No SIC or IFRIC
3. A bound volume of standards that could fit any sized pocket
4. A bound volume of standards that could be afforded by any pocket
5. Chairman of IASC was not on the front page of the *Financial Times* every day
6. Board of IASC entirely part-time
7. Staff of 4
8. Many options in standards
9. No Illustrative examples, application guidance, implementation guidance or basis for conclusions
10. No listing of approving or dissenting board members

skilled politicians, they did not understand it. Aside from the auditors, there were no regulators to speak of, at least outside the US. It is surprising that we were able to stretch out our work to 5.30pm.

Peter Holgate
London
(Aged 56¼, 49¾?)

Response from the publisher

IFRS news publisher Mary Dolson agrees with the author[1] and his yearning for the charm of those simpler days, when the accounting standards would fit in her Diane von Furstenberg handbag. However, while 14 professional full-time paid standard-setters and their small army of staff closely watched by the mighty of the business world have much to answer for in creating complexity of accounting standards, some of this complexity reflects the complex business environment that we all work in. Measuring the obligation for final salary schemes may have led to their steep decline, but surely it's better for shareholders to know the extent of the company's obligations.

The five significant areas in which accounting has improved during my career are in the area of share-based payments, pensions, financial instruments, business combinations accounting (banning poolings) and the requirement to present a cash flow statement. My personal opinion is that all of these resulted in significantly better information for users of financial statements.

1 Mary refuses to disclose details about age, although you can apparently find this on Facebook.

Sudokhu solution

1	8	4	5	2	6	7	9	3
5	9	7	1	3	8	2	4	6
2	6	3	7	4	9	8	5	1
8	4	6	9	7	5	3	1	2
3	1	9	6	8	2	5	7	4
7	2	5	3	1	4	6	8	9
9	3	1	2	5	7	4	6	8
6	5	8	4	9	3	1	2	7
4	7	2	8	6	1	9	3	5

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How the credit crisis may affect deferred tax balances

What is the issue?

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

In the current economic environment, many entities are making significant finance-related decisions and grappling with new accounting issues (such as asset impairment and breaches of debt covenants). In economic times like this, it's important for entities to be aware of the tax impacts of accounting decisions to ensure that tax planning opportunities are capitalised and tax risks are appropriately considered.

In this edition of *IFRS in brief*, we highlight some of the accounting issues that have important tax implications, which can affect entities' bottom line results.

Who does it impact?

In this article we focus on entities that:

1. are likely to assess their assets for impairment in their next set of accounts and entities with foreign operations;
2. may be materially impacted by changes to accounting estimates as a result of today's market conditions;
3. are considering re-financing or re-structuring to mitigate debt covenants; and/or
4. have foreign subsidiaries or are foreign owned.

Common accounting scenarios that have important tax implications

1. Entities likely to assess their assets for impairment at June/Dec 2009 and entities with foreign operations

Tax deductible interest expense: Entities that will write down their assets in their next set of accounts should be aware that the ability to claim a tax deduction for borrowing costs can be limited by the tax thin capitalisation requirements in certain jurisdictions. The level of tax deductible interest is based on the entity's net assets, which is calculated using the accounting values reported in the financial statements. Asset impairments, other write downs and increases in provisions reduce entities' net assets and therefore could reduce the amount of interest that entities can deduct for tax purposes. This would result in higher income tax expense and lower net profit for entities in that year. Entities with foreign operations should consider their current financing structure to ensure it continues to provide the most tax effective outcome.

2. Entities that may be materially impacted by changes to accounting estimates

Recognition of deferred tax assets (DTAs): In today's economic climate, entities' trading outlooks may change significantly (for example, due to reduced sales forecasts) which may impact their ability to recognise a DTA. A DTA is recognised only when it is probable that future taxable profits will be available to the entity. Management should ensure their appraisal of whether to recognise a DTA is consistent with other assumptions and analysis in the business, including the cash flow assumptions used in the entity's impairment assessment.

3. Entities that are considering re-financing / re-structuring to mitigate the risk of breaching debt covenants

Avoiding a debt covenant breach: Many entities have debt covenants built into their financing arrangements, and some entities may have recently breached these or had some 'close calls'. This might have been because the drop in economic activity has reduced the entity's operating performance, the entity had to write down the value of some assets, or the entity's financier has become more stringent on its interpretation of covenants. Some entities will try to avoid breaching their debt covenants through an equity injection from a foreign parent, calling in an inter-company loan from a foreign subsidiary or parent entity, or by forgiving inter-company debt. Management should be aware that these activities could affect the availability of tax losses. Even where there are no tax losses and debts are forgiven, other tax attributes (such as the tax depreciation base) may be reduced. These tax issues may be mitigated with time and careful planning, provided the accountants and taxation experts work together.

4. Entities that have foreign subsidiaries or are foreign owned

Repatriation of foreign profits: In the past, entities with foreign subsidiaries might not have recognised deferred tax liabilities (DTLs) on their investments because it seemed unlikely that subsidiaries' profits would be distributed in the foreseeable future. In the current environment, many entities will require additional funding and are more likely to repatriate profits or call in inter-company loans from their foreign subsidiaries. The intention to repatriate foreign subsidiary earnings will result in the recognition of a DTL if, on distribution, these profits are subject to foreign withholding taxes or corporate taxes. This will be the case even where the foreign investment is eliminated on consolidation.

PwC insight: Consider the tax implications of accounting issues and involve the tax experts

Today's economic climate presents entities with a number of accounting and tax challenges. We believe the best way to reach the right accounting outcome whilst managing the tax risks and opportunities is by ensuring entities' finance, treasury and tax functions are working together. Collaboration on business issues will help entities to manage their tax risks, to utilise tax planning opportunities, and to make important finance decisions that benefit the entity overall.

29 July 2009

Impairment testing - value in use calculation

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

What is the issue?

In today's challenging economic conditions, more entities will be testing their assets and cash generating units (CGUs) for impairment. To do this entities will need to compare the carrying amounts of their assets and CGUs with their recoverable amounts, which are measured at the higher of fair value less costs to sell and value in use.

The recoverable amount of assets or CGUs using the value in use calculation is determined by measuring the present value of the future cash flows expected over the useful life of the asset or CGU in its present condition. The impairment standard, IAS 36, requires the value in use calculation to be performed using pre-tax cash flows and a pre-tax discount rate. However, this can be easier said than done. In practice, it is often difficult to obtain a pre tax discount rate because most of the observable market rates for equity are post tax.

In this edition of *IFRS in brief*, we remind entities how to determine the pre-tax discount rate and get the accounting right for impairment testing that's performed using a value in use calculation.

Who does it impact?

Entities that have goodwill and non-amortising intangible assets and/or assets that have impairment indicators.

What do entities need to be aware of?

Entities are reminded that a post tax discount rate, such as the weighted average cost of capital (the 'WACC'), is appropriate to determine the recoverable amount of assets/CGUs based on their value in use. The WACC reflects the percentage of each source of capital (such as debt or equity), and the cost of each source of capital (such as the return on equity or the interest rate on debt). However, entities should ensure that if a post tax discount rate is used for the value in use calculation, the expected future cash flows should also be post tax to ensure consistency. Importantly, the tax line cash flows should reflect the specific amount and timing of tax payments and/or any refunds expected.

Entities should ensure the post tax discount rate is adjusted for the specific risks associated with the cash flows of the asset/CGU (such as currency or price risk) if the cash flows are not already adjusted for it. All economic transactions take risks into account and each asset/CGU will have different risks, which need to be factored into the calculation. However, the discount rate should not be adjusted to mitigate risks that should be reflected in the cash flows.

Entities should also be aware of their disclosure obligations. Under IAS 36 *Impairment of Assets*, entities are required to disclose the pre tax discount rate used for the value in use calculation.

How do entities determine the pre-tax discount rate?

The pre tax discount rate is not obtained by simply grossing up the post tax discount rate by a standard rate of tax. That's because the pre-tax rate needs to take account of the asset or CGU's tax rate, the post tax discount rate, the timing of the future cash flows, and the useful life of the asset or CGUs. Below is a summary of how entities can determine the implicit pre-tax discount rate using post-tax data.

Step 1: How to calculate value in use using a post tax discount rate

- From pre-tax cash flow projections, expected tax cash payments are calculated on an ungeared basis to arrive at post-tax cash flows (after-tax cash flows).
- These after-tax cash flows are discounted at an appropriate post tax discount rate that's based on information which is freely available on the capital markets.
- Following these steps will generate the asset's/CGU's value in use.

Step 2: How to determine the pre tax discount rate

- From the pre-tax cash flow projections the entity should 'solve' the discount rate, which would give the same value in use determined in Step 1 when applied to the pre tax cash flows.
- This rate is the pre tax discount rate, which should be disclosed in the financial statements.

Note. Entities should not take the tax amount to be simply earnings before income tax multiplied by the tax rate. That calculation won't reflect the actual tax cash payments expected for the asset or CGU. Actual cash tax payments will be affected by factors such as temporary differences and the utilisation of future tax losses.

PwC insight: In most cases the weighted average cost of capital is a good starting point

In our experience, an entity's WACC measurement (as opposed to its incremental borrowing rate or other market borrowing rate) is usually a good reflection of the risk that is specific to the asset or CGU, provided that it is similar to the rate a market participant would use.

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PRICEWATERHOUSECOOPERS

IFRS news

Emerging issues and practical guidance*

Supplement – July/August 2009

IFRS 3R and IAS 27R – questions and answers

The revised standards on business combinations and consolidation (IFRS 3 (revised) and IAS 27 (revised)) significantly change the accounting for business combinations and transactions with non-controlling interests. These changes will create challenges and may change how management negotiates and structures transactions. This supplement is the first in a series of questions and answers on the revised standards.

This instalment looks at changes in the recognition and measurement of assets and liabilities and in the measurement of consideration, thereby affecting goodwill. Further instalments will consider presentation in the income and cash flow statements and other topics related to transactions with non-controlling interests. A complete discussion of the revised standards is available in PricewaterhouseCoopers' *Global Guide to Accounting for Business Combinations and Noncontrolling Interests* and *IFRS Manual of Accounting*.

Assets and liabilities

The revised standards have resulted in a few changes to the recognition and measurement of assets and liabilities in the acquisition balance sheet. The existing requirement to recognise all of the identifiable assets and liabilities of the acquiree is retained, with most assets and liabilities recognised at fair value. Some areas to watch out for relate to restructuring costs and modifications to acquiree pension plans, indemnification assets and non-compete agreements.

Restructuring costs and modifications to acquiree pension plans

Many business combinations are promptly followed by major restructurings of the acquired business and by changes in the acquiree's share-based payment and employee benefit plans. Specific guidance is included in the revised standards that address changes in share-based payment plans of the acquired business, including changes introduced by the acquisition agreement. An acquirer that is obliged to replace an acquiree's share-based compensation awards includes all or a portion of the market-based measure of replacement awards in the measurement of consideration. The acquirer is 'obliged' if the employees have the ability to enforce replacement of the awards. This could occur, for example, if the terms of the acquisition agreement require replacement or if the plan itself has a pre-existing change of control clause requiring replacement.

By analogy to the share-based payment guidance in IFRS 3 (revised), questions arise as to whether an acquirer can 'obligate' itself to modify the acquiree's pension plans or to implement a restructuring plan and therefore include the related obligations as part of

acquisition accounting. The following questions and answers address these situations.

1. **Can liabilities for modifications to defined benefit pension plans be included as part of the purchase consideration of a business combination if the modifications are written into the acquisition agreement and appear to be an obligation of the acquirer?**

   The modification of pension plans written into acquisition agreements are generally treated separately from a business combination. IFRS 3 (revised) paragraphs 51-52 require separate accounting for transactions that are not part of a business combination, even if entered into simultaneously. Paragraph 52 specifies that a transaction that primarily benefits the acquirer is likely to be a separate transaction. It also indicates that a transaction that remunerates employees of the acquiree for future services is a separate transaction. An acquirer generally initiates a modification of a pension plan for its own benefit. The modification will also typically relate to future services of the employees and should therefore be recorded as adjustments to future compensation expense. Paragraph B50 provides further interpretive guidance of factors to consider when evaluating what is part of a business combination.

   Treating a pension modification separately from a business combination is in fact theoretically consistent with the underlying approach taken in IFRS 3 (revised) with replacement share-based compensation awards. To the extent replacement awards are vested, the corresponding portion of the fair value of the awards is included in consideration. It receives this treatment because it relates to employees acting in their capacity as shareholders. The portion of the fair value of the replacement awards for the unvested element, however, represents future compensation expense, as it relates to future service of the employees. Similarly, a modified pension plan relates to future service of employees.

2. **Can restructuring costs be included as purchase consideration of a business combination if the restructuring activities are written into the acquisition agreement and appear to be an obligation of the acquirer?**

   IFRS 3 (revised) paragraph 11 specifically refers to the treatment of restructuring costs and assumes that all restructuring costs would be a post-acquisition cost. These costs arise as a result of management's intention rather than obligation. Including a plan for restructuring in the acquisition agreement does not create a liability of the acquiree at the acquisition date.

   A restructuring provision can only be recorded as a liability of the acquired business when it is a liability of the acquiree at the acquisition date. This would only arise if the planned restructuring met the conditions as a constructive obligation of the acquiree in accordance with IAS 37 prior to the business combination and was not done for the benefit of the acquirer. If done for the benefit of the acquirer, management accounts for the restructuring as a separate transaction.

Indemnification assets

The seller in a business combination may contractually indemnify the acquirer for the outcome of a contingency or uncertainty related to all or part of a specific asset or liability (the indemnified item). The acquirer, in accordance with IFRS 3 (revised) paragraph 27, recognises an indemnification asset at the same time that it recognises the indemnified item measured on the same basis as the indemnified item.

The following questions and answers address the application of indemnification accounting under the revised standards.

1. **Can indemnification asset accounting be applied to general representations and warranties?**

   Indemnification asset accounting only applies to indemnification arrangements when the outcome of a contingency or uncertainty relates to a specific asset or liability. The guidance should typically not be applied to general representations and warranties.

2. **Does indemnification asset accounting follow the IFRS 3 (revised) guidance when the indemnified item has not been recognised at the acquisition date or during the measurement period?**

   The indemnification may relate to an acquired asset or assumed liability, or one that is not recognised on the acquisition date. For example, an indemnification may relate to a contingent liability that is not recognised at the acquisition date because its fair value is not reliably measurable at that date. In those circumstances, the indemnification asset is also not recognised at the acquisition date. Rather the indemnification asset is recognised at the same time as the indemnified item and measured on the same basis, subject to collectibility and any contractual limitations on the indemnified amount. This applies whenever the indemnified item is recognised regardless of whether it is at the acquisition date or during or after the measurement period.

3. **Does an indemnification arrangement need to be specified in the acquisition agreement to achieve indemnification accounting?**

   Indemnification accounting can still apply even if the indemnification arrangement is the subject of a separate agreement. Indemnification accounting applies as long as the arrangement is entered into on the acquisition date, is an agreement reached between the acquirer and seller, and relates to a specific contingency or uncertainty as part of a business combination.

Non-compete agreements

A non-compete agreement generally prohibits former owners or key employees from competing with the business. An agreement usually covers a set period of time that typically commences after a change in control or the termination of employment. Non-compete agreements are most common in service businesses where relationships with key customers are crucial, such as investment management. The following questions and answers address the accounting for non-compete agreements entered into at the time of a business combination.

1. **Is a non-compete agreement treated as part of a business combination or as a separate transaction?**

   Non-compete agreements established at the time of a business combination are generally accounted for as separate transactions if they are entered into by or on behalf of the acquirer or primarily for the benefit of the acquirer [IFRS 3R.52]. A non-compete agreement negotiated as part of a business combination will typically be initiated by the acquirer to protect the interests of the acquirer and the combined entity. A non-compete agreement may have been part of an employment contract or shareholder agreement that was in place before the business combination. In those circumstances, the non-compete agreement would represent an intangible asset of the acquired business.

2. **What is the accounting for a non-compete agreement that is treated separately?**

   Non-compete agreements often meet the criteria for separate recognition as an intangible asset under IAS 38 by satisfying the contractual or other legal-right criterion for an asset acquisition. See question 3 below for the accounting in those instances. The combined entity should, however, consider whether any payments made as a result of the non-compete are in fact compensation for future services to be accounted for in accordance with IAS 19. A 'non-compete' that results in a payment made after some period of employment with the acquired business will usually have an element of compensation.

3. **What is the subsequent accounting of a non-compete agreement that is recognised as an intangible asset?**

   A non-compete agreement will normally have a finite life, requiring amortisation of the asset. The amortisation period should reflect the periods over which the benefits from the non-compete agreement are derived. Determining the period is a matter of judgement in which all terms of the agreement, including restrictions on enforceability of the agreement, should be considered. Amortisation will typically be recognised on a straight-line basis.

Measurement of consideration and goodwill

The revised standards introduced changes to the measurement of consideration transferred. Goodwill continues to be a residual, although with the changes to consideration transferred, there is likely to be a different residual amount under the revised standards. One of the most significant differences may arise from the treatment of contingent consideration under the revised standards. There have also been clarifications from the Board that will impact the amount of consideration transferred and goodwill.

Contingent consideration – classification

Contingent consideration is recognised and measured at fair value as of the acquisition date regardless of whether it is probable that the contingent consideration will be paid. The contingent consideration is included in consideration transferred and therefore impacts the amount of goodwill at the acquisition date. The accounting subsequent to the acquisition date, however, depends on the classification of contingent consideration as either an asset/liability or an equity instrument. The accounting subsequent to the acquisition date will not impact goodwill. Previously, contingent consideration was only recognised if probable, and any changes in contingent consideration after the acquisition date were recorded as adjustments to goodwill.

Liability-classified contingent consideration under the revised standards is re-measured to fair value through the income statement each reporting date. Contingent consideration classified as equity is not re-measured in subsequent periods. One of the challenges of the revised standards is determining whether share-settled contingent consideration arrangements are classified as a liability or equity. The following questions and answers address this challenge.

1. **When is share-settled contingent consideration classified as a liability?**

   Liability classification is required when a variable number of shares are to be issued [IAS 32.11]. The following features typically identify an arrangement as having a variable number of shares and thus classified as a liability.
   - Fixed value to be paid (number of shares to be issued adjusted to pay a specific amount).
   - Multiple performance targets.
   - Cumulative performance targets.

   Two examples of liability classified arrangements are given below.

   Example 1
   If a performance target of C100 of net income is achieved in year 1, 100 additional shares will be issued; otherwise a pro

rata number of shares will be issued down to a minimum performance target of C75 of net income.

Analysis
A variable number of shares will be issued depending on which of the multiple performance targets (range between C75 and C100) are met; it is therefore classified as a liability.

Example 2
If the share price of the combined entity of C50 is achieved, additional shares to the value of C100 will be issued.

Analysis
A variable number of shares will be issued to the value of C100; it is therefore classified as a liability.

2. When is share-settled contingent consideration classified as equity?

Equity-classified contingent consideration occurs when a fixed number of shares is to be issued [IAS 32.16]. The following features typically identify an arrangement as having equity classification.

- Explicit terms indicating a fixed number of shares will be issued.
- Either all or none of the shares will be issued – the arrangement does not provide for a variable number of shares to be issued.
- A single performance target is used to determine if shares will be issued.

Two examples of equity-classified arrangements are given below.

Example 1
If performance target of C100 of net income is achieved in year 1, 100 additional shares will be issued; otherwise, no additional shares will be issued.

Analysis
A fixed number of shares (100) will be issued if a single performance target is achieved. Failure to meet the performance target results in no shares being issued; it is therefore classified as equity.

Example 2
If the target market price per share of C100 is achieved by the end of year 1, 100 additional shares will be issued; otherwise, no additional shares will be issued.

Analysis
A fixed number of shares (100) will be issued if a single performance target is achieved. Failure to meet the performance target results in no shares being issued; it is therefore classified as equity. The use of a market performance target (share price) does not prevent equity classification provided the features needed for equity classification are present.

3. Can arrangements with multiple performance targets be classified as equity?

Equity classification may be possible with multiple performance targets, but it depends on a careful analysis of the features of the arrangements. Arrangements that contain multiple performance targets can be equity-classified if each performance target is separate and independent from the other performance targets and the performance targets are not cumulative. Performance targets that are separate and independent must have independent risks from all other targets (that is, year 1 risks need to be separate and independent from year 2 risks). These types of arrangement will individually result in the delivery of a fixed number of shares for each target; as a result, each would be classified as equity.

The following is an example of a multiple performance target arrangement that qualifies as equity because each year's performance target and related risk is considered separate and non-cumulative.

Equity classified

- If a performance target of C100 of net income in year 1 is achieved, 100 additional shares will be issued; otherwise, no additional shares will be issued; and
- If a performance target of C150 of net income in year 2 is achieved (regardless of whether year 1 target is achieved), 120 additional shares will be issued; otherwise, no additional shares will be issued.

By contrast, the following is an example of a multiple performance target arrangement that is classified as a liability. The targets are in effect cumulative and the underlying risk related to achieving the year 2 target is dependent on the year 1 risk. This differs from the equity-classified example wherein year 1 and year 2 were, in effect, two separate and independent arrangements.

Liability classified

- If in year 1 a performance target of C100 of net income is achieved, 80 additional shares will be issued; otherwise, no additional shares will be issued; and
- Additionally, if in year 2 a performance target of C180 of cumulative net income since acquisition date is achieved, 100 additional shares will be issued; otherwise, no additional shares will be issued.

4. Does the length of the performance target period impact classification?

Contingent consideration arrangements typically contain annual performance targets. However, longer or shorter periods may be used and, if defined appropriately, may be classified as equity provided each period and target is independent from the others. Judgement is needed, however, to ascertain whether the use of shorter periods in substance results in a variable number of shares to be issued and thus is a liability arrangement.

Contingent consideration – earlier transactions

All contingent consideration arrangements were outside the scope of IAS 39 under the previous version of IFRS 3. The scope exemption has been removed as part of the consequential amendments relating to the revised standards. It was not clear how contingent consideration arrangements arising from transactions originally accounted for under the previous version of IFRS 3 should be treated once the scope exemption in IAS 39 was removed.

The transition provisions of IFRS 3 (revised) were explicit that it is applied prospectively to new transactions, with the exception of one area of deferred tax accounting. However, there were no explicit transition provisions for the change to IAS 39.

1. **How has the Board clarified the treatment of pre-adoption contingent consideration arrangements?**

   The Board tentatively decided, in May 2009, to clarify that the financial instruments standards (IFRS 7, IAS 32 and IAS 39) do not apply to pre-adoption contingent consideration arrangements. Therefore, contingent consideration arrangements from business combinations that were completed prior to the revised standard taking effect continue to be treated in accordance with the standard in effect at the time of the business combination.

2. **When will this clarification take effect?**

   The clarification is expected to be part of the annual improvements exposed in 2009 for publication in 2010. Improvements are usually mandatory for the following year but often can be early adopted. However, the tentative Board decision represents a clarification and supports our previously held view on this question.

Existing contingent consideration arrangements of an acquiree

IFRS does not have specific guidance on the accounting for contingent consideration arrangements of the acquired business. The Board, at its June 2009 meeting, tentatively concluded that such arrangements would not constitute contingent consideration under IFRS 3 (revised) because the consideration does not arise from the current transaction between the acquirer and the former owners of the acquiree. Rather, contingent consideration arrangements of the acquiree would be liabilities (or in some instances, an asset) of the acquired business. These arrangements would almost always be established by contract and fall within the scope of IAS 39 and be recognised at fair value on the acquisition date. The subsequent accounting would be driven by the classification of the asset or liability under IAS 39.

Contracts between an acquirer and a vendor in a business combination

The 2009 annual improvements project narrowed the existing scope exemptions in IAS 39 that relate to contracts between an acquirer and a vendor in a business combination to buy or sell an acquiree at a future date. The Board has amended IAS 39 to clarify that only forward contracts between an acquirer and selling shareholder to buy or sell an acquiree that result in a business combination at a future date qualify for a scope exemption. This will bring more contracts into the scope of IAS 39. The following question and answer addresses some of the practical implications of this clarification.

1. **What types of contract are now likely to be within the scope of IAS 39 as a result of the clarification and therefore subject to fair value accounting?**

   Options, warrants and convertible instruments that could give control of an entity to one party are now likely to be within the scope of IAS 39. Puts and calls with matched terms are frequently observed in business combinations and have the same economic consequences as a forward contract. However, an option contract allows one party to control the occurrence or non-occurrence of the future business combination depending on whether the option is exercised. Therefore, the business combination is not firmly committed and so will not meet the 'that result in a business combination at a future date' criteria.

Summary

The mandatory adoption date of the revised standards is quickly approaching (that is, for annual periods starting on or after 1 July 2009). Recognising that the new guidance will change the way companies account for business combinations, the above questions and answers address some of the new challenges. Stay tuned for part two of this series that focuses on financial statement presentation.