

IFRS News

Shedding light on the IASB's activities*

IFRS News – Issue 29
April 2005

In this issue...

- 1 Issue of the month**
Impairment testing
- 3 IAS 19 amendments**
Implications for 2006
- 4 Quasi-equity loans**
A functional strategy?
- 6 Interview**
PwC's John Brendon
- 7 IASB update**
IASB and IFRIC timetables
- 8 Contacts**

Issue of the month

Impairment testing under IFRS and US GAAP

Many companies are now tackling the application of the revised standards on business combinations, intangible assets and impairment testing introduced by the IASB last year. The aim of the new standards was to achieve greater convergence between IFRS and US GAAP but many differences remain, not least in the area of impairment testing. Caroline Woodward explains.

Consider a European mobile telecoms entity that is also a US registrant. The entity has an existing '2G' business. It also has a '3G' licence that management believes has an indefinite useful life. The licence must be tested for impairment annually under IFRS and US GAAP. This article considers how the process differs under the two regimes.

IFRS

The 3G licence does not generate independent cash flows and so must be tested for impairment as part of a cash-generating unit (CGU). Management considers its business, both 2G and 3G, to be a single CGU. Its cash flow forecasts for this business unit over the next few years include the capital expenditure required to expand the network as more consumers switch to 3G, and the associated increased revenues. The 3G licence has been placed in service as the commercial launch of 3G services has occurred.

The recoverable amount of the licence may be estimated based on fair value less costs to sell, or on value in use (VIU) under IAS 36R. Management would prefer fair value less costs to sell, as this enables the use of prepared forecasts that are based on management's plans for expansion. These plans are similar to those that other market participants would have and should be included in any assessment of the value of the business unit in an arm's length transaction. However, there are no recent market transactions in similar businesses to support management's estimate of fair value. Absent some market data to support fair value, it cannot be used to estimate recoverable amount. Recoverable amount for impairment testing must therefore be estimated based on VIU.

Management prepares a cash flow analysis in accordance with the requirements of IAS 36R for a VIU calculation.

The cash flows should be based on the asset in its current condition and exclude any cash inflows or outflows that are expected to arise from improving or enhancing the asset's performance. The cash flows related to the capital expenditure that is required to expand the 3G network and the associated enhanced cash inflows must be excluded from management's forecasts.

The recoverable amount under VIU is less than the carrying amount of the CGU; an impairment loss should be recognised. This will be applied, pro rata, first to any goodwill allocated to the CGU and then to the other assets in the CGU, including the licence, based on the carrying amounts of those assets. It may be possible to reverse the impairment loss in subsequent years as the entity progressively rolls out its 3G network, except to the extent that the loss has been applied to goodwill. Goodwill impairments are never reversed.

US GAAP

The licence must be tested for impairment in isolation and not as part of a reporting unit under US GAAP (SFAS 142), as it is an asset with an indefinite useful life; a reporting unit under US GAAP is similar to a CGU under IFRS. Management should compare the carrying amount of the

licence to its fair value to determine whether it is impaired.

Fair value may be estimated, for US GAAP purposes, using either comparable market transactions or discounted cash flow techniques. The problem is that there have been no recent sales of 3G licences, and so management is unable to estimate fair value by reference to comparable market transactions. It must estimate the fair value of the licence using another valuation method.

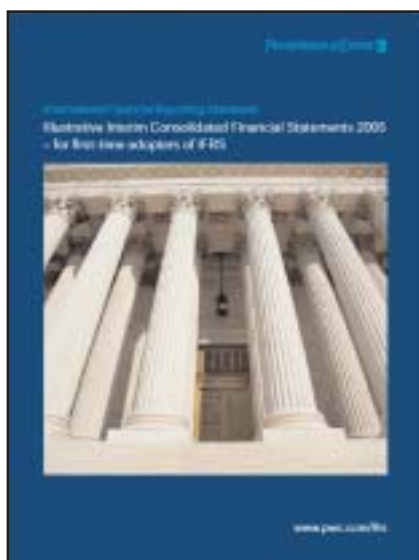
The licence does not generate independent cash flows; management has estimated its fair value in earlier years using discounted cash flow techniques and the residual value method. This method has been widely applied to the valuation of assets that do not generate independent cash flows or for which it is difficult to identify cash flows directly associated with the asset. The residual method starts with the entity's total cash flows and deducts from them the cash flows for all assets to which cash flows can be directly attributed. This leaves a residual cash flow that is deemed to be attributable to the asset in question, and of course, to any goodwill. Management understands that this is the least robust valuation method but the company, and most others in the sector, has used it as the only practical option for valuing its 3G licence.

This year management knows it cannot use this method as it is no longer valid to estimate the fair value of an asset under SFAS 141, the standard on business combinations, because there can be only one residual – goodwill. SEC registrants can no longer use this method, but should instead use a direct method and reperform the impairment tests from earlier years that have been carried out using the residual method.

Management learns that its valuation advisers have developed a model using direct methods to value 3G licences that is already being used successfully by other telecoms entities. The value of the licence under the new approach is below its carrying amount; an impairment loss is recognised under US GAAP, which cannot be reversed in later years.

Summary

This example demonstrates that there are significant differences between IFRS and US GAAP in the impairment testing process for indefinite lived intangible assets. It is necessary to carry out two completely separate reviews for impairment, which may well yield different results. The process is complex and entities should ensure that sufficient resource is allocated to the task and that effective systems are in place to facilitate impairment testing.



'Illustrative Interim Financial Statements 2005 – for first-time adopters of IFRS'

This new publication provides an illustrative set of full consolidated financial statements for an entity's first interim reporting period under IFRS.

The fictional entity will prepare its first annual financial statements for the year ended 31 December 2005. Its regulator, however, requires it to publish financial information in accordance with IAS 34 for the six months ended 30 June 2005.

This publication uses all standards and interpretations in force at 31 December 2004 as the basis for the accounting policies applied.

For hard copies of publication, contact your local PwC office. Electronic copies are available at: www.pwc.com/ifrs



IAS 19 amendments

GCRG's actuarial expert Richard Davis looks at the implications of some of the recent amendments to IAS 19.

The IASB published amendments to IAS 19 on 16 December 2004. They covered four areas:

1. introduction of a new option for recognition of actuarial gains and losses;
2. changes to disclosure requirements;
3. clarification of the treatment of multi-employer plans; and
4. changes to the treatment of group plans that cover entities under common control.

This article considers the changes to the treatment of gains and losses and the disclosure requirements. Next month we will look at points 3 and 4.

The changes to the standard are effective from 1 January 2006, although early adoption is permitted for periods ending after 16 December 2004. Changes that are adopted early must be applied in full – cherry-picking is not permitted.

Recognition of gains and losses

IAS 19 specifies a minimum recognition requirement for actuarial gains and losses: where the cumulative gain or loss exceeds 10% of the greater of the value of plan assets or the defined benefit obligation, the excess must be amortised over the expected average remaining working lives of employees who participate in the plan. Any other consistent approach would also be acceptable. A consequence of this deferred recognition for gains and losses is that, at any point in time, the amount recognised on the balance sheet is simply a timing difference and has no real meaning. A plan in deficit may give a balance sheet pre-payment or vice versa. The immediate recognition of gains and losses provides a more meaningful

balance sheet number; however, the resulting volatility of profits has been unattractive but transparent. The option of recognition through equity rather than the income statement makes immediate recognition a more palatable proposition.

The immediate recognition of gains and losses must go through a Statement of Recognised Gains and Losses (SoRIE). The SoRIE is one of the presentations of movement in equity permitted by IAS 1. A company that adopts the 'immediate recognition through equity' approach is required to present the statement of changes in equity in the SoRIE format. In other words, it should include only the information specified in IAS 1.96, rather than the columnar presentation allowed by IAS 1. Management should show in the notes rather than on the face of the financial statements, disclosures required by IAS 1.97 (ie, transactions with shareholders and reconciliation of each class of equity or reserves, including retained earnings).

If gains and losses are recognised in the SoRIE, any impact of the recoverability test-limit on the value of a balance sheet asset must also be taken through the SoRIE. There is no recycling through profit and loss once gains or losses have been recognised in equity.

Disclosure requirements

The disclosure requirements introduced in 1998 have remained unchanged except for the modifications in 2000 regarding plan assets and in 2002 regarding the asset ceiling. The standard requires more information to be disclosed on the assumptions underlying the defined benefit cost and trends in the related assets and liabilities. It also converges with US GAAP disclosure requirements.

The most helpful change in the disclosure requirements is the separate presentation of assets and liabilities.

Companies must provide a reconciliation under current IAS 19 of the movement in the balance sheet over the year. The new requirements look at the development of the defined benefit obligation and the assets separately, and then reconcile these amounts to the balance sheet. This is the SFAS 132 approach, and provides the information in a more comprehensible way.

The new requirements include:

- more detail about plan assets;
- an analysis by category (as a minimum, equity, debt, property and other assets) and details of any 'self investment'; and
- a description of how the assumption has been set for future investment returns.

Management must provide a sensitivity indication for post-retirement medical benefits, showing the impact of a 1% increase or decrease in the assumed rate of increase in medical costs on the plan liabilities and the sum of the service and interest costs. This special treatment for medical expenses comes from US GAAP. The extent of these liabilities in the US can be substantial, and the range of assumptions regarding future inflation in medical expenses is broader than many other assumptions; the accounts user would want, therefore, to adjust this number rather than the pensions results.

Management should disclose the cumulative amount of gains and losses recognised through equity where it has adopted this recognition option. This appears as either an anti-abuse measure (if the amount is an ever-increasing tally of losses, it may suggest that the adopted assumptions are overly optimistic) or possibly a step that keeps open future options for changing the standard, such as the introduction of a

requirement to recycle gains and losses that have been recognised in equity through profit and loss.

A further anti-abuse disclosure is the introduction of a five-year record showing the defined benefit obligation, the fair value of plan assets and the resulting surplus or deficit, and the 'experience adjustments' in each year on the assets and liabilities. 'Experience adjustments' arise from divergence between actual experience and the assumptions; they exclude gains and losses arising from a change in assumptions. This record can

be created on a prospective basis; there is no requirement to give details for earlier periods that are not included in comparatives.

Another helpful item for looking at future cash flows is 'the employer's best estimate, as soon as it can reasonably be determined, of contributions expected to be paid to the plan during the annual period beginning after the balance sheet date'.

Consider the preparation of an actuarial valuation. The result is likely to be an extended negotiation on how a deficit will

be funded between the employer and the plan. The employer may have a view on the outcome of those negotiations and it may be more expensive than his opening negotiation position. It is hard to imagine that an employer would be willing to prejudice their negotiating position by disclosing that they expect to concede agreement to pay an extra €8m in the coming year when the outcomes might range from paying an extra €4m a year for 20 years to paying an extra €25m a year for three years.

IAS 19 disclosures are likely to get longer.

Quasi-equity loans



Quasi-equity loans – a functional strategy?

GCRG's Marc Minet and Reto Zemp consider some of the restrictive aspects of quasi-equity loans under IAS 21R.



Foreign exchange gains and losses that arise from a net investment in a subsidiary with a different functional currency (a foreign operation) can be deferred in equity until disposal or substantial partial disposal of the foreign operation. What forms the net investment is a crucial question because it drives the amount of deferral that is allowed. Net investment is restricted to monetary items that meet certain restrictive criteria.

Only monetary items for which settlement is neither planned nor likely to occur in the foreseeable future can form part of the net investment in a foreign operation. For example, a loan used to finance capital equipment and investment without a stated repayment date that is also not expected to be repaid might form part of a net investment. These loans are often described as quasi-equity. A working capital loan for inventory or liquidity purposes that is routinely repaid when the foreign operation has surplus cash would not qualify as part of the net investment. Foreign exchange gains and losses on the working capital loan will be recognised in the income statement when incurred.

This concept of quasi-equity exists in most national GAAP. Use of long-term investment loans is often tax efficient and is a key element of treasury strategy for many large multinationals. The concepts are similar, but the rules in IAS 21(revised) may be more restrictive than those under national GAAP. First-time users of IFRS will need to consider whether existing treasury strategies still work under IFRS (ie, continue to achieve deferral). Continuing preparers also need to be aware of the changes to IAS 21R from the improvements project that tightened some aspects of the standard.

This article considers some of the restrictive aspects of quasi-equity under IAS 21R.

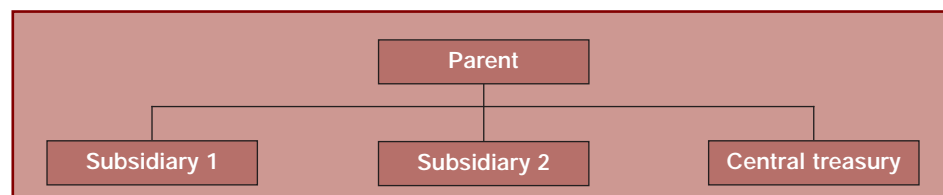
Monetary items that qualify as net investment in a foreign operation

A monetary item for which settlement is neither planned nor likely to occur in the

foreseeable future is a part of the entity's net investment in a foreign operation. Exchange rate differences are recognised in a separate component of equity in the consolidated financial statements, referred to as cumulative translation adjustment (CTA). The intercompany balances must arise between a reporting entity and its foreign operation (that is its subsidiary, joint-venture, associate or branch) and be denominated in the functional currency of the reporting entity or the foreign operation.

For example, a loan from a parent company (see diagram below) to its foreign operation, Subsidiary 1, would qualify for net investment treatment if it met the criteria:

- settlement is not planned or likely to occur, and
- it is denominated in the functional currency of the parent or Subsidiary 1.



A loan from Subsidiary 1 to Subsidiary 2, even if it met the other criteria would not qualify for net investment treatment because S2 is not an associate, joint venture, subsidiary or branch of S1.

Intermediate holding company

A reporting entity under IAS 21 is not necessarily the reporting entity that is preparing consolidated accounts. A reporting entity is any entity that produces financial statements. An intermediate holding company (IHC) is a reporting entity, and monetary items between an IHC and a foreign operation could qualify as net investment in a foreign operation over which the IHC has control, joint control or significant influence. The reclassification of exchange differences to equity occurs when the IHC and the foreign operation are included within a set of consolidated accounts, irrespective of whether the consolidated accounts are prepared by the IHC, its parent or its parent's parent.

Central treasury

A group might establish a treasury centre to manage and pool the group's liquid resources and borrowings on a centralised basis. Operating entities typically transfer surplus liquidity to the treasury centre, which provides financing to other group entities in need of cash. A treasury centre will have significant intercompany balances. Some of these balances might not be planned or likely to be settled in the foreseeable future and might be denominated in the functional currency of either party to the loan. The exchange differences on an intercompany monetary item between a treasury centre and an operating entity could only be taken to equity in consolidation if the operating entity is a subsidiary, associate, joint venture or branch of the treasury centre. They would remain in profit or loss if the treasury centre and the operating entity were fellow subsidiaries. The Board sees a need to amend the standard in this area.

Referring to the diagram on p4, any loans from the central treasury (CT) to S1 or S2 would not qualify for net investment treatment because S1 and S2 are not subsidiaries, joint ventures, branches or associates of CT.

Disposal and partial disposal of a foreign operation

The CTA relating to a foreign operation should be recognised in the income statement on disposal of the foreign operation. The CTA is released when the gain or loss on disposal is recognised. An entity may dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital or abandonment of all or part of the entity. In the case of a partial disposal, a proportionate share of CTA should be released to profit or loss.

Repayment of quasi-equity

A repayment of a monetary item that forms part of a reporting entity's net investment in a foreign operation constitutes a partial disposal of a foreign operation. It is the same as a partial repayment of share capital.

The proportion of the partial disposal is determined as the amount repaid in relation to the total net investment in that foreign operation when the partial disposal takes place. The amount of the CTA to be released to profit or loss is calculated by multiplying the proportion of the partial disposal by the cumulative amount of exchange differences related to that foreign operation. This includes exchange differences relating to quasi-equity and exchange differences resulting from the translation of the foreign operations' functional currency to the group's presentation currency.

The repayment of quasi-equity could bring into question whether the designation of the loan as part of the reporting entity's net investment in a foreign operation was appropriate at inception; it could also challenge the

designation of other such loans that are not yet repaid.

US GAAP differences

SFAS 52, which is the US GAAP guidance applicable to foreign currency translation, does not restrict the eligibility for net investment accounting to intercompany items that arise between a reporting entity and a foreign operation. Exchange differences on monetary items between fellow subsidiaries might be taken to equity under SFAS 52 if the transactions are of a long-term investment nature (that is, settlement is not planned or anticipated in the foreseeable future). IAS 21 does not permit net investment accounting for intercompany transactions that arise between fellow subsidiaries.

Deferred cumulative translation adjustments are released to profit or loss under SFAS 52 only when there is complete or substantially complete liquidation of a foreign operation. If the foreign operation is only partially liquidated (for example, only 30% of the foreign operation is liquidated), no proportion of the cumulative amount of exchange differences is released to profit or loss. Under IAS 21, a proportion of the CTA would be released upon a partial liquidation. This difference applies only to partial liquidations. If an entity sells part of its ownership interest in a foreign operation, a proportion of the CTA attributable to that investment should be recognised in the gain or loss on sale.

Conclusion

First-time adopters could find that the accounting for quasi-equity is different under IFRS than under previous GAAP. They may need to keep exchange differences that were previously taken to equity in profit or loss or restructure the intercompany financing. Existing preparers could face similar issues, as IAS 21R has been tightened. Quasi-equity could also be a source of GAAP differences for foreign private issuers, and the amounts involved could be material.



Getting the best IFRS interpretation

John Brendon, PwC's global leader of accounting services, talks to IFRS News about his role in ensuring the high-quality and consistency of the firm's IFRS advice worldwide.

What are your main responsibilities?

I was appointed PwC's global leader of accounting consulting services in May last year. IFRS is a very hot topic in Europe and many other countries around the world. This, combined with IFRS convergence with US GAAP, means that I have the challenge of improving the firm's infrastructure and processes to ensure consistency in the advice we give worldwide.

We already had the firm's Global IFRS Board and Global Corporate Reporting Group (GCRG) working towards this goal. My job is to provide wider leadership and to work with GCRG leader Ian Wright, other national technical partners and engagement partners to ensure we give the best IFRS interpretations that we can. For example, we have brought in new procedures so that the IFRS financial statements of all first-time adopters listed on major indices around the world are reviewed centrally for quality and consistency. GCRG is organising this round of reviews for 2005, and the countries are working hard to get the financial statements ready at national level.

I have also been working with PwC's global assurance leader, Jerry Ward, in the implementation of a unified accounting consulting structure for IFRS with more rigorous consultation and documentation processes, which will reflect those adopted for US GAAP and the Public Company Accounting Oversight Board.

In doing this, I am driving for more cohesiveness between our national accounting technical departments, our regional accounting centres of excellence

and the global accounting consulting groups, getting them to work together as a team – again with the aim of improving quality and consistency. These consulting groups include a regional office that the Eurofirm is putting together, which would include an accounting technical function, risk management, regulatory and auditing specialisms. Similar groups are being formed in other parts of the world, for example, in Asia – in Hong Kong/China a centre of excellence has been established to cover the region.

I also spend quite a bit of time with the Eurofirm and with Pierre Coll, chairman of the firm's global accounting committee, which sets overall direction of policy, with the Global IFRS Board and on IFRS technical panel issues.

My other key role is in the area of independence, where I work on global policy. I am also the UK firm's independence and ethics partner.

To what extent do you get involved on a technical level?

One of my responsibilities is to facilitate discussions where difficult accounting technical questions arise. The local technical teams and GCRG deal with tough issues, but if something very sensitive comes up, I will join in to ensure we reach as good a solution as we can.

Sometimes it's a question of getting people used to the problem. IFRS represents a huge cultural and behavioural shift in the way we think and it will take a lot of time for all involved to get to grips with it. So I facilitate the engagement teams understand why IFRS has been written the

way it has, and this helps them explain our accounting decisions to the client.

Are these queries likely to subside as companies/auditors become more familiar with the standards?

I don't see this happening. I think the types of query may change, but they will continue. The first-time adoption issues will ease, but the regulators will almost certainly realise companies haven't got it all right and refinements and restatements will be necessary. Convergence with US GAAP will also raise new issues.

What do you see as the big IFRS issues going forward?

We won't just be dealing with conversion issues and financial statements signed off by auditors; there will be additional IFRS-related work. A major area where we will see a growth in queries is with respect to prospectuses. IFRS will have to be used in prospectuses across the EU, as required by the Prospectus Directive, mandatory from July this year. Issues such as how these documents are presented, including local interpretations of the Directive, and the role of accountants will require our advice.

Another key area will be how consistency is achieved on IFRS, with various accounting standard-setters and regulators giving interpretative decisions. There will be a lot of pressure on firms like PwC to come up with consistent views. There is also the continuing debate as to what extent IFRS is principles-driven, as inevitably in 2,200 pages of standards, there are a lot of detailed requirements. The key issue is how much more details there will be to underpin the principles.

Biography – John Brendon

- Lead audit partner on major PwC client Jardine Matheson
- Leader of the firm's Global Accounting Services
- Member of PwC UK's Assurance Technical Forum
- Member of the PwC UK Supervisory Board
- Chairman of the UK firm's Audit, Risk and Independence Committee
- Global leader for Independence in Assurance Services
- UK firm's partner responsible for independence and ethics.

IASB project timetable

Project	ED published/ expected	Comment deadline	Standard published/ expected
IAS 39 – Fair value option	21 April 2004	21 July 2004	Quarter 2, 2005
Convergence			
– IAS 37	Quarter 1, 2005	Undecided	Some time in 2005
– Post-employment benefits (not on IASB site)	Undecided	Undecided	Undecided
– IAS 12	After Quarter 2, 2005	Undecided	Undecided
– Amendment to IAS 20	Quarter 2, 2005	Some time in 2005	Some time in 2005
– Disclosures about segments (replacement of IAS 14)	After Quarter 2, 2005	Undecided	Undecided
Short-term convergence:			
– Segment reporting	Undecided	Undecided	Undecided
– Income taxes	Undecided	Undecided	Undecided
– Accounting changes and error corrections	Undecided	Undecided	Undecided
Business combinations and related issues (FASB and IASB joint project)			
– IFRS 3, Phase 2: application of purchase method	Quarter 2, 2005	Some time in 2005	Some time in 2006
– Minority interests: amendment to IAS 27	Timing expected to match IFRS 3, phase 2		
– Intangibles: amendment to IAS 38	Quarter 2, 2005	Some time in 2005	Some time in 2005
Revenue and related liabilities (FASB and IASB joint project)	Discussion paper due after Quarter 2, 2005	Undecided	Undecided
Reporting comprehensive income (FASB/IASB/ASB project)	Discussion paper due after Quarter 2, 2005.	Undecided	Undecided
IFRS 4 – phase 2	Undecided	Undecided	Undecided
IAS 32			
– Financial Instruments: Disclosures (ED 7)	22 July 2004	22 October 2004	June 2005
– Financial instruments disclosures: shares puttable at fair value	After Quarter 2, 2005	Undecided	Undecided
Consolidation (including SPEs)	After Quarter 2, 2005	Undecided	Undecided
IAS 39			
– Amendments to IAS 39, Cash Flow Hedge Accounting of Forecast Intragroup Transactions	8 July 2004	8 October 2004	Quarter 2, 2005
– Financial guarantee contracts and credit insurance	8 July 2004	8 October 2004	Quarter 2, 2005
– Interest margin hedging	To be decided	To be decided	To be decided
Liabilities and equity	Under deliberation by FASB (see Revenue and related liabilities , above). IASB will add modified joint projects to its agenda when FASB is ready to publish discussion document.		
Standards for Non-Publicly Accountable Entities (formerly: SMEs)	Discussion paper issued June 2004; comment deadline 24 September 2004. Roundtable expected September 2005. ED expected first half of 2006		

Note: these dates are provisional only and subject to change

IFRIC project timetable

Project	ED published	Comment deadline	Final interpretation published/due
D5, Applying IAS 29, Financial Reporting in Hyperinflationary Economies for the First Time	11 March 2004	14 May 2004	Quarter 2, 2005
D6, Multi-employer Plans	6 May 2004	9 July 2004	Some time in 2005
D9, Employee Benefit Plans with Promised Return on Contributions or Promised Contributions	8 July 2004	21 September 2004	Quarter 2, 2005
D10, Liabilities arising from Participating in a Specific Market - Waste Electrical and Electronic Equipment	25 November 2004	11 February 2005	Some time in 2005
D11, Changes in Contributions to Employee Share Purchase Plans	16 December 2004	1 March 2005	Some time in 2005
D12, Service Concession Arrangements - Determining the Accounting Model	3 March 2005	3 May 2005	
D13, Service Concession Arrangements - the Financial Asset Model	3 March 2005	3 May 2005	
D14, Service Concession Arrangements - the Intangible Asset Model	3 March 2005	3 May 2005	
D15, Reassessment of Embedded Derivatives	1 April 2005	31 May 2005	Some time in 2005

Note: these dates are provisional only and subject to change

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