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IFRS News

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Issue of the month

Withdrawal of IFRIC 3

The IASB has withdrawn IFRIC 3, Emission Rights, following a request from the IFRIC to consider alternative solutions to emission rights accounting.

The Board's concerns about IFRIC 3 arose from two accounting 'mismatches'. One mismatch related to the different measurement bases for the emission rights asset and the liability arising from the emission of pollutants. The other related to the timing of recognition: allowances are recognised at the start of the scheme year, which is when they are issued, whereas the liability is recognised as emissions are made. These two mismatches appeared to generate volatility in the income statement.

The EU Accounting Regulatory Committee (ARC) was also concerned about the interpretation of the need for fair values to be used for the measurement of allowances prior to the establishment of a liquid market. The European Financial Reporting Advisory Group, which advises the ARC on the endorsement of standards and interpretations, had recommended that IFRIC 3 should not be endorsed for use.

The IASB commented that IFRIC 3 was a correct interpretation of the standard as it exists; the standards themselves failed to adequately address the accounting for emission rights. The withdrawal does not invalidate its interpretation of the standards but now means that other valid interpretations of the existing standards can also be applied.

Alternatives to IFRIC 3

Alternative interpretations are therefore limited to situations where: an entity believes that the components of a cap and trade scheme are different from an intangible asset; an obligation to deliver allowances and a grant; or an entity believes that IAS 38, IAS 37 and IAS 20 can be applied differently from the way proposed by the IFRIC.

An entity that chooses to apply an accounting policy that differs from IFRIC 3 must ensure that its analysis of the components of the scheme – or its application of the standards – is as robust as that of the IFRIC. The entity must measure its accounting policies against the explanation of the IFRIC's discussions in the 'Basis for Conclusions' set out in IFRIC 3.

The IFRIC's thorough discussion of these issues suggests that the development of alternative solutions that comply with the existing standards will be difficult. It is unlikely that entities will avoid the accounting mismatch that led to the withdrawal of IFRIC 3 until the IASB is able to address the constraints in the existing standards, including potential changes to IAS 20, IAS 38 and IAS 39.

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Radical new proposals for business combinations

The IASB has recently released an exposure draft proposing radical changes to IFRS 3, Business Combinations, and some amendments to IAS 27 dealing with minority interests. The proposals will mean significant changes to the way companies record acquisitions and transactions with minority interests. Michael Gaull explains the implications.

IFRS 3, Business Combinations, introduced significant changes to existing practice; but retained the cost-based model that underpins business combinations accounting in IFRS and other frameworks. The key features are:

- Pooling is prohibited and an acquirer must be identified in all cases.
- The cost of an acquisition is the fair value of the consideration plus transaction costs.
- Contingent consideration is recognised if payment is probable and subsequent adjustments affect goodwill.
- Most acquired intangible assets are recognised at fair value.
- The costs of restructuring planned by the acquirer are not recognised.
- Goodwill is not amortised but is tested for impairment annually.
- Minority interest reflects the minority's interest in the net assets, excluding goodwill.
- Existing goodwill is not remeasured in a step acquisition.

Do the proposals address the practical problems with IFRS 3?

Most companies now accept that purchase accounting is the most appropriate way to account for business combinations. IFRS 3 addressed many of the issues with the previous model. Many of the practical problems in business combinations accounting arise in areas excluded from the scope of IFRS 3, such as group reorganisations and the formation of joint ventures. The new proposals will not provide guidance in these areas. There are other difficulties with the existing literature: for example, the treatment of transactions with minority interests and the distinction between contingent and deferred consideration. The proposals provide additional guidance for the contingent consideration; but not in the way people might expect.

What has the IASB proposed?

Three fundamental changes to the existing accounting model underpin the IASB's proposals:

- A fair value model will replace the cost allocation model in IFRS 3.
- The basis for recognising some of the assets and liabilities acquired in a business combination and the way it is measured will change.
- Transactions with minority shareholders will be treated as equity transactions.

The fair value model will require that:

- An acquired business is recorded initially at fair value rather than cost. An acquirer that obtains less than 100% of the target must calculate the fair value of the business acquired and attribute a portion of the goodwill to the minority interest. This is unlikely to be simply grossing up the price paid and will introduce additional subjectivity to purchase accounting.
- The fair value of an acquired business does not include the costs of acquiring it; all transaction costs will be charged in the income statement. These charges might be significant, this change will make the costs associated with deals transparent.
- Purchase consideration is also recorded at fair value, including any contingent element. Any differences between the fair value estimated at the date of acquisition and the amount actually paid will be recognised in the income statement; the liability will effectively be marked to market. This will introduce significant volatility – particularly in industries where milestone-based contingent consideration is used, such as pharmaceuticals and technology. The proposed accounting has an apparent paradox: the good news that a subsidiary has achieved a significant milestone might result in the payment of additional contingent consideration and a charge in the income statement.
- The recognition of the acquired business at fair value means any existing interest owned by the acquirer before it obtained control will be remeasured at fair value at the date of acquisition, with any gain or loss recognised in the income statement. Companies that acquire control in stages will record a 'gain or loss on acquisition'.

There will also be some changes to the way in which some of the assets and liabilities acquired in a business combination are recognised and measured:

- There will be new guidance to distinguish between liabilities recognised at acquisition and liabilities recognised by a charge in the post-acquisition income statement. The proposals are complex and might result in additional income statement charges.
- The notions of contingent assets and liabilities will be divided into:

conditional rights and obligations; and unconditional rights and obligations. For example, the right to take action for a breach of contract is an unconditional right and the right to receive settlement is a conditional right. Unconditional rights and obligations will be recognised but conditional rights and obligations will not. Acquirers will probably record more assets and fewer liabilities than they do under IFRS 3. They may find it challenging to identify and measure reliably all of these items.

- The settlement of any existing contracts between the acquirer and target will be excluded from purchase accounting. For example, a customer that acquired its supplier would record the settlement of the purchase contract in the income statement rather than part of the purchase consideration.
- There will be specific guidance on the allocation of share awards made in connection with an acquisition between purchase consideration and post-acquisition income statement.

There is currently no guidance in IFRS dealing with the purchase and sale of minority interests. Many companies treat these as transactions with independent third parties. They record goodwill on purchases and a gain or loss on disposals. The recent improvements to IAS 27 concluded that minority interests are equity participants in the group that should be presented within equity. The concept of the minority as an equity participant has been extended and the IASB has proposed that:

- The purchase of a minority is in substance a return of capital or a distribution of capital that should be deducted from equity; and
- The sale of shares to a minority is in substance a capital contribution that should be added to equity.

The financial statements of companies that regularly buy and sell minority interests could appear different when these proposals are applied; the acquisition of a minority, which reduces net assets and gains on disposal, will no longer appear in the income statement.

Conclusion

The exposure drafts are a large step forward in the IASB's convergence project with the US Financial Accounting Standards Board. The two Boards have issued nearly identical exposure drafts for comment at the same time. The proposals will almost fully converge IFRS and US GAAP accounting for business combinations and will therefore have a similar effect on companies throughout the world.

These proposals will radically change the way business combinations and transactions with minority interests affect the financial statements. The balance sheets or results of some companies could be significantly altered. It is not clear, however, if the accounting community has focused on these developments during the IASB's deliberations.

The radical nature of some of the proposals is likely to give rise to spirited responses in comment letters and IASB/FASB roundtables.

IAS 39

Amendment to IAS 39: the fair value option

The IASB recently issued its long-awaited amendment to the fair value option, contained in the 2003 revision of IAS 39. GCRG's Jessica Taurae looks at the impact of the amendment and the issues surrounding it.

IAS 39 previously allowed an entity to designate any financial asset or financial liability to be measured at fair value with changes in value recognised in profit or loss. Some constituents – primarily prudential supervisors of banks, securities companies and insurers – were concerned that this unrestricted option might be used inappropriately. The EU's decision to include the fair value option in its 'carve out' of IAS 39 reflected these concerns: the fair value option cannot currently be applied to the liabilities of EU companies.

The IASB, in response to these concerns, published an exposure draft in April 2004 proposing some restrictions to the option's use. Following consultation the Board has now revised the fair value option.

The requirements

The amendments permit the fair value option to be used only when doing so results in more relevant information because either:

- it eliminates or significantly reduces a measurement or recognition inconsistency ('accounting mismatch') that would otherwise arise from measuring assets or liabilities, or recognising the gains and losses on them on different bases; or
- a group of financial assets and/or financial liabilities or both is managed and its performance is evaluated on a fair value basis, in accordance with a documented risk management or investment strategy and information about the assets and or liabilities is

provided internally to the entity's key management (as defined in IAS 24).

If a contract contains one or more embedded derivatives, an entity may apply the fair value option to the entire combined contract unless:

- that embedded derivative does not significantly modify the cash flows that otherwise would be required by the contract; or
- it is clear with little or no analysis that separation of the embedded derivative is prohibited.

The amendments still require items that use the fair value option to be designated on initial recognition. The use of the option is an accounting policy choice and therefore entities must disclose the criteria for using it. This disclosure includes a narrative description of how using the option is consistent with the entity's documented risk management or investment strategy when criterion (ii) is used (see page 5).

Effective date and transition

The amendments are applicable for annual periods beginning on or after 1 January 2006 with earlier application encouraged. The matrix below explains the transition requirements for existing preparers and first-time adopters of IFRS.

	Existing preparer	First-time adopter of IFRS
Annual periods beginning before 1 January 2006 (i.e. the entity early adopts the amendment)	• Permitted to designate any previously recognised financial asset or financial liability that meets the new criteria at the start of the period or, if later, at the date of initial recognition. • Deadline of 1 September 2005 to make such designations; thereafter such designations can only be made on initial recognition. • Must de-designate any previously designated asset or liability if it does not meet the new criteria. • Must restate comparative information for any designated financial assets or liabilities provided the criteria were met at the beginning of the comparative period or, if later, on the date of initial recognition.	• Permitted at the start of its first IFRS reporting period to designate any financial asset or financial liability that then meets the new criteria (or meets the criteria at the date of initial recognition if later). • Deadline same as for existing preparers • If the entity restates comparative information for IAS 39, it must also restate that information for these amendments for any designated financial assets or liabilities provided the criteria were met at the beginning of the comparative period or, if later, on their date of initial recognition.
Annual periods beginning on/after 1 January 2006 (i.e. the entity does not early adopt the amendments) and before 1 September 2006	• Must de-designate any previously designated asset or liability if it does not meet the new criteria. • Not permitted to designate any previously recognised financial assets or financial liabilities. • Must restate comparative information for any designated financial assets or liabilities provided the criteria were met at the beginning of the comparative period or, if later, on their date of initial recognition.	• Permitted to designate at the date of transition to IFRS any financial asset or financial liability, provided it then meets the new criteria. • Must restate comparative information for any designated financial assets or liabilities provided the criteria were met at the beginning of the comparative period or on their date of initial recognition. Companies have until 1 September 2005 to make such designations.
Annual periods beginning on/after 1 September 2006	• Not applicable	• Permitted at the date of transition to IFRS to designate any financial asset or financial liability provided it meets the criteria at that date.

Implications

The fair value option is likely to simplify the application of IAS 39 for some entities.

Criterion (i) – accounting mismatch

The option can be used in place of fair value hedge accounting to deal with a measurement mismatch. It can also eliminate the problems that arise from a mixed measurement model where financial assets are measured at fair value and related financial liabilities are measured at amortised cost. An entity may have liabilities whose cash flows are contractually based on the performance of assets that are otherwise classified as available-for-sale. The option, in this case, will reduce the mismatch which arises from taking changes in the expected cash flows of the liabilities to profit or loss while the fair value movement on the related assets are taken to equity.

Criterion (ii) – managed on a fair value basis

The option may avoid any inconsistency between management and statutory reporting for a group of financial assets and liabilities that are managed and evaluated on a fair value basis. Some profit and loss reporting on a fair value basis must be prepared and provided internally to the entity's key management to qualify under this criterion. It is not sufficient for assets to be managed using a Value at Risk (VaR) methodology.

Criterion (iii) – embedded derivatives

The option will eliminate the burden of identifying all of the embedded derivatives, determining which are required to be separated under IAS 39 and valuing those that are required to be separated. It may be simpler to use the option to value the entire instrument; this could result in more reliable measures. This should be helpful for the structured products issued by banks and similar entities that may contain several embedded derivatives.

Conclusion

The amended fair value option will enable many entities to simplify the application of IAS 39 and avoid anomalies. There is, however, still one hurdle: the EU needs to endorse the amendment in order for European entities to apply the fair value option to liabilities. The endorsement process has begun and hopefully all entities will be able to take advantage of this simplification of the standard.

Revisions to IAS 1

Disclosures on judgements and estimates

The revisions to IAS 1 have created two new disclosure requirements. These aim to provide users of accounts with an insight into the critical judgements and estimates management make to apply the entity's accounting policies. Matthieu Moussy and Gabor Balazs explain.

The application of accounting policies is not always straightforward; transactions are becoming more complex and the economic environment evolves rapidly. The preparation of financial statements involves more critical judgements and sophisticated estimates. But how transparent should these decisions be?

How can a company benefit from the adequate disclosures of judgements and estimates?

Estimation uncertainties

An IFRS preparer in previous years could include a short sentence in the financial statements, along the lines of 'the company's review of the useful lives of property, plant and equipment did not result in a change of depreciation rates'. This type of disclosure, however, is not helpful for the reader of the accounts.

The new requirements, introduced by the improvement project, require more detailed disclosures. It will be necessary to describe the uncertainties that could cause changes in the useful lives and the key assumptions which management used to determine their estimates.

Accounting judgements

The disclosure of critical judgements highlights significant areas where management's decisions can determine the accounting for a transaction. For example, a company has a sales agreement where the buyer has the right of return if a certain percentage of the products are faulty from the first month's delivery. The timing of revenue recognition will depend on management's judgement – whether the conditions for return will be met or not. The revised standards require management to disclose these decisions if they have a material impact on the amounts recognised in the financial statements.

Managing risks and expectations

There is no doubt that the users of financial statements, analysts in particular, welcome these changes. Management, however, could argue that these disclosures are potentially burdensome and could result in the disclosure of sensitive information on strategy or short-term action plans. This is not necessarily true. Disclosures can be extensive but most of the underlying information has

already been produced to meet the recognition and measurement criteria of other standards or because other standards already require it (like IAS 36 on the assumptions used for impairment calculations). Management does not need to expose sensitive data to provide meaningful information for readers. The disclosures relate to events that are already reflected in the financial statements. The standard clarifies that it does not require the disclosure of budget or forecast information.

Only judgements and estimates that have a significant risk of causing material adjustment within twelve months must be disclosed. A handful of items will meet this definition for most companies.

Conclusion

Appropriate use of these disclosures will allow readers of the financial statements to recognise difficult areas and potential risks. The readers will be able to determine if they are correctly addressed. Companies will also be in a better position to explain any variances in future performance as the uncertainties have already been disclosed. Poor disclosures, however, could create problems. Readers will question what control management has over these key judgements and estimates. The standard offers an exception from the requirements based on impracticability; the use of this exemption should be limited to very rare situations.

Possible sources of estimation uncertainties:

- Changes in foreign exchange rates and affecting assets or liabilities denominated in foreign currencies;
- Assumptions to determine amount of provisions;
- Interest rates, affecting pension liabilities and impairment calculations;
- Useful lives and residual values of fixed assets;
- Technological obsolescence of inventories;
- Property prices used as the basis for revaluing properties;
- Growth rates and interest used in an impairment calculation for property, plant and equipment;
- Assessment of the percentage of completion on services or construction contracts.

Possible areas of critical accounting judgements:

- Classification of held-to-maturity financial assets;
- Revenue recognition: transfer of substantially all significant risk and rewards;
- Classification of complex lease transactions;
- Impairment of an available-for-sale investment;
- Control over a special purpose entity.

Focus on financial instruments

The European Financial Reporting Advisory Group's recently established working group on financial instruments convened for the first time last month. Two of the group's members, PwC's Gordon Ireland and Agnes Tardos, talk to IFRS News about the group's mandate.

Gordon Ireland

How did you become a member of the working group?

The UK's Consultative Committee of Accountancy Bodies proposed that I be put forward for EFRAG's Financial Instruments and Insurance Accounting Working Groups. I ultimately chose to apply for the Financial Instruments Working Group because I believe the future of insurance accounting will be driven by financial instruments accounting and my involvement with this group is likely to be more beneficial to the insurance community.

The group has a balance of members representing different industries [see box on next page], as it is important that we look at the issues in their widest context. The chairman is keen that this doesn't become a lobbying body on behalf of a particular industry.

Why was the working group set up?

EFRAG has had a working group which looks at the development of IAS 39 for some time. However, there was a need to refresh the group with new members to reflect the agenda of the IASB's Financial Instruments Working Group, including the revisions to the fair value option and other IFRS developments in the future. EFRAG needs proactively to provide input to assist the IASB in developing IAS 39.

How are the group's discussions fed back?

EFRAG's Technical Experts Group (TEG) seeks guidance from its specialists who sit on a number of working groups (insurance, revenue recognition and small and medium-sized entities, in addition to financial instruments) and have detailed knowledge of the particular accounting topic. These groups brief the TEG on critical IFRS issues as the standards are developed. After discussion, the TEG then gets the EFRAG seal of approval and passes its findings on to the IASB.

What is on the FI Working Group's agenda?

Our agenda is driven by the desire to parallel and influence the efforts of the IASB. The working group briefs EFRAG representatives at the IASB on the Board's agenda before the IASB meetings take place.

The first topic that we have discussed is EFRAG's response to the endorsement of the fair value option. The objective is to fast-track the issue because everyone in the EU badly needs the implementation of the fair value option as part of the stable platform. We had a brief debate on the principles underlying the proposals and then a longer discussion about the transition arrangements. These discussions will assist EFRAG in giving further comments back to the IASB.

Other issues on the IASB working party's agenda, and therefore ours, are: hedge accounting; the component approach to measurement; measurement categories; and derecognition criteria.

Another hot topic is 'own credit risk'. We need to discuss this to see if a component-based approach could help to address current disagreement on whether entities should account for 'own credit risk' in the measurement of financial liabilities.

Agnes Tardos

How did you become a member of the working group?

I was nominated by the Fédération des Experts Comptables Européens' banking committee, which I also sit on. I represent central and Eastern Europe on EFRAG's working group and have a lot of experience in financial instruments.

What do you hope to achieve?

My personal agenda is to help resolve the problem of the EU applying a different set of IFRSs from the rest of the world. It won't be easy; the debate is emotional and political issues are involved. The partial endorsement of IAS 39 was not based only on technical arguments. I would like to take the debate back to the technical level and reach a compromise based on technical issues.

EFRAG intends to be proactive in its contribution to the process. It is an important player, but it is just one of those providing input. It is the IASB that takes the decisions. We want to influence the IASB's agenda – it would be good if EFRAG could be a strong voice for the EU. But we do not want to interfere in the whole standard-setting process. Our primary goal is to create a reasonable and meaningful dialogue and provide input to the IASB discussions.

Membership of the working group

EFRAG's Financial Instruments Working Group is made up of: representatives from the financial services sector and non-financial industries, and from a variety of backgrounds including preparers of financial statements of banks and insurance companies,auditors, users, academics and standard-setters:

- Thomas Naumann, Dresdner Bank (Chairman) (German)
- David Bradbery, UBS Investment Bank (UK)
- Isabelle Collignon, Crédit Agricole SA (French)
- Petri Hofste, KPMG (Dutch)
- Gordon Ireland, PwC (UK)
- Victor Jimenez, Banco Bilbao Vizcaya Argentaria (Spanish)
- Ingvar Linse, Swedbank (Swedish)
- Helmut Ortolf, DZ Bank AG (German)
- Massimo Romano, Assicurazioni Generali (Italian)
- Hugh Shields, Barclays Capital (UK)
- Agnes Tardos, PwC (Hungarian)

Objectives of the working group

- To prepare papers as discussion bases, with the aim of ensuring that European views are taken into account at the IASB;
- To prepare papers as preliminary views of EFRAG (after approval by EFRAG's Technical Experts Group);
- To be seen as pro-active by EFRAG and relevant groups in Europe;
- To expose preliminary views together with roundtable discussions, where necessary; and
- To produce papers to be used as discussion bases for the EFRAG Advisory Forum.

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