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IFRS News

Shedding light on the IASB's activities*

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Issue of the month

Convergence on deferred tax

Ever wanted to make a room full of accountants laugh? Suggest that the deferred tax liability is the number that will be paid in cash, and see what happens. Deferred tax is an area of accounting where application of the current guidance can produce some results that startle management, are not understood by users and where similar principles in IFRS and US GAAP can give different results – sometimes strikingly so. The IASB and FASB have a convergence project at the moment that is looking to converge the detailed requirements in the relevant standards. They expect to issue Exposure Drafts during Quarter 2, 2005. This article, by Juraj Tucny, examines some of the expected changes to IAS 12.

IAS 12 and FAS 109 require the comprehensive recognition of deferred taxes, based on the temporary differences between the carrying amounts and tax bases of assets and liabilities. However, IFRS and US GAAP differ in the detail, including the exceptions and exemptions.

The IASB agreed to amend IAS 12 as follows:

- Modify the definition of tax base and the definition of the temporary difference, and as a result introduce a concept of permanent differences;
- Eliminate the initial recognition exemption;
- Retain the exemption for recognition of deferred tax liabilities for investments in subsidiaries but change the wording to that used in US GAAP; and
- Require classification of deferred taxes as either current or non-current based on classification of the underlying asset or liability.
- These decisions are tentative and may change.

Definition of a tax base and permanent differences

The definition of 'tax base' will state that it is a measurement attribute under existing tax law. The tax base will be the present asset, liability or equity instrument recognised for tax purposes as a result of one or more past events. That asset, liability or equity

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instrument may or may not be recognised in the IFRS balance sheet.

The concept of assets, liabilities and equity instruments for tax purposes (a tax balance sheet) may not be intuitive in many countries. The revised standard will therefore contain additional guidance to clarify that these are the amounts that would be recognised in a balance sheet created using tax law as the basis for accounting. The tax balance sheet would be prepared using the tax law that would apply to the taxpayer given its elections and status under the various provisions of the law. The tax balance sheet of a taxpayer who elects the cash basis would differ from a taxpayer who elects an accrual basis for determining taxable profits under the tax law.

Implications

There are several consequences of the change to the definition of the tax base.

1. The tax base will be a function of tax law under the new definition. The concept that management intent as to the manner of recovery (or settlement) of the carrying amount of an asset (or liability) can affect the tax base will be eliminated.

   Example: The depreciation of an office building is not deductible for tax purposes; however, a deduction for the original cost will be available at sale. The tax base depends on management's intent under current IAS 12: it is the cost of the building if management expects to sell it; or zero if they expect to recover the building's value through use. The tax base would be the cost under the converged standards.

2. The concept of 'permanent differences' will be introduced. All differences between tax bases of assets and liabilities and their carrying amounts are temporary differences under current IAS 12. Transactions that do not have tax consequences are dealt with through a counter-intuitive definition of the tax base.

   Example: Today, a liability recorded in a tax balance sheet at its nominal amount of 100, but at its present value of 90 in the IFRS balance sheet, has a tax base of 90 if the unwinding of the discount of 10 is not a tax deductible expense. The definition of the liability's tax base is its IFRS carrying amount less any amount that will be deductible for tax purposes in respect of that liability in the future. The liability's tax base would be 100 under revised IAS 12, which is the amount recorded in the tax balance sheet. The difference of 10 would be a 'permanent difference'. The effect of the two approaches is the same: no deferred tax is recognised because the transaction has no tax consequences. It will not result in a higher or lower amount of income tax paid in the future.

Initial recognition exemption

The most significant impact of the IAS 12 revisions is likely to come from the removal of the initial recognition exemption.

Current IAS 12 prohibits recognition of a deferred tax liability or deferred tax asset for temporary differences that arise from the initial recognition of an asset or liability in a transaction that is not a business combination and, at the time of the transaction, affects neither accounting nor taxable profit. No such exemption is available under US GAAP. The deferred tax is recognised using the 'simultaneous equation' method specified in EITF 98-11.

The Boards agreed that neither of the existing approaches provides useful information. They will propose that such transactions should be accounted for as follows:

- The asset acquired should be measured at its fair value when recognised; the asset's measurement will assume full tax deductibility;
- A deferred tax asset or liability should be measured as the difference between the fair value of the asset and its tax base multiplied by the tax rate; and
- Any difference between the amount paid and the amounts recognised in the balance sheet for the asset and related deferred tax should be recognised in the balance sheet as 'a purchase discount allowance on the deferred tax' and amortised to profit or loss when the related tax is realised.

The proposed treatment introduces implicit discounting of deferred taxes, which is contrary to current requirements. However, a purchase discount reflects what is actually going on in many transactions. Entities purchase deferred tax assets at a discount due to the time value of money – for example, if future tax deductions exceed the amount paid for an asset, or if an investment tax credit is attached to an asset. The Boards have yet to finalise the proposal.

IAS 12 will also be revised to require explicitly the recognition of a deferred tax asset as part of acquisition accounting if tax goodwill exceeds IFRS goodwill.

Permanently reinvested earnings of subsidiaries

Current IAS 12 provides an exemption from the recognition of a deferred tax liability for taxable temporary differences relating to investments in subsidiaries, associates and joint ventures. US GAAP has a similar exemption for foreign subsidiaries and foreign corporate joint ventures.

The Boards have decided to retain the exemption. However, the IASB will amend the language in IAS 12 so that it is similar to that in FAS 109 and APB Opinion No 23, Accounting for Income Taxes – Special Areas.

Intraperiod tax allocation

IAS 12 requires the tax effects of transactions charged directly to equity in the same or different period also to be charged to equity. US GAAP has a similar requirement but differs in its guidance for subsequent changes in tax amounts previously recognised in equity.

US GAAP has detailed intraperiod allocation rules. It requires subsequent changes in tax assets or liabilities from changes in tax laws or rates, changes in tax status and changes in estimates of the realisability of deferred tax assets to

be recognised in the income statement, even if the tax asset or liability has arisen from an equity transaction.

The IASB has concerns over the FAS 109 intraperiod tax allocation methodology, and convergence is yet to be achieved.

Other convergence issues

Other issues under discussion include:

- **Measurement at enacted versus substantively enacted tax rate.** The IASB will clarify that 'substantively enacted' in IAS 12 means that any anticipated change in the tax rate is virtually certain. The FASB will clarify in FAS 109 that enactment occurs when every action, other than perfunctory actions, has occurred that is required for a measure to become law.

- **Measurement at distributed versus undistributed tax rate.** The FASB will use the distributed rate to measure deferred taxes. The IASB will continue to use the undistributed rate.

- **Accounting for the recognition of an acquirer's deferred tax benefits as a result of a business combination.** Previously unrecognised deferred tax assets of the acquirer that become realisable as a result of acquisition of a subsidiary are not included in the accounting for the business combination under IAS 12. This is not the case under US GAAP.

The Boards will try to resolve some of the divergences between the standards in a meeting next month.

Juraj Tucny is a senior manager in PwC's Global Corporate Reporting Group.

IFRIC 3

Accounting for global warming

The Kyoto Protocol on global warming came into force last month. Michael Stewart looks at IFRIC's guidance for emitters of greenhouse gases.

The Kyoto Protocol commits the European Union to reduce total emissions of greenhouse gases to 92% of their 1990 levels in the period 2008-12. The EU Emissions Trading Scheme, effective from 1 January 2005, is a response to this challenge. Companies in power generation, refineries, ferrous metals, pulp and paper, and building materials sectors are now subject to a 'cap and trade' system of emissions control, to encourage reductions in carbon dioxide emissions.

Cap and trade schemes

Entities subject to the schemes are given allowances that permit them to emit a certain volume of greenhouse gases in a given year. The more allowances they are given, the more emissions they can make without penalty. The entity must hand back to the government, at the end of the year, sufficient allowances to cover the volume of emissions it has made.

A typical scheme provides both a stick and a carrot:

- Allocating fewer allowances than are needed to cover current levels of emissions and charging penalties for shortfalls in allowances handed back to the government at the end of the year; and

- Allowing entities that reduce their emissions below the level for which they have been given allowances to profit from the sale of their excess allowances.

The cap and trade schemes permit the trading of allowances at any time. Some entities may choose to buy and sell allowances to take advantage of changes in the market price or as a hedge against other market changes.

IFRIC response

The IFRIC has issued guidance on how emitters of greenhouse gases participating in a cap and trade scheme should account for the scheme's impact. IFRIC 3, Emission Rights, provides guidance on how to account for the allowances held and the obligation to return allowances and/or pay a fine at the end of the emission scheme year.

IFRIC 3 requires the allowances to be accounted for as intangible assets in accordance with IAS 38. This applies to allowances received free of charge from the government and purchased allowances.

Allowances received from the government are recognised at fair value. A corresponding deferred income balance is recognised in accordance with IAS 20, Accounting for Government Grants and Disclosure of Government Assistance. Purchased allowances are recognised at cost.

An active market for allowances will develop in many countries. Entities in those countries may therefore choose between the cost model and the revaluation model in IAS 38 for the subsequent measurement of allowances. The revaluation model requires the allowances to be marked to market, with changes in fair value recognised in equity through the statement of changes in equity.

IAS 38 requires intangible assets to be amortised to reflect the consumption of economic benefits. The economic benefit of an emission allowance is its use to satisfy an entity's obligations to the

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government arising from greenhouse gas emissions. Allowances are not amortised but are derecognised when they are returned to the government or sold to another entity.

The deferred income balance should, however, be amortised during the year. The balance represents the value of the allowances given by the government that permit the entity to emit a certain volume of greenhouse gases without penalty. The amortisation method should reflect the pattern of consumption of that benefit. Amortisation of the deferred income should therefore be on a unit-of-emission basis, reflecting the volume of emissions made for the year to date and the expected emissions for the full year. This will be relevant for entities whose emissions vary over the course of the year.

The obligation to deliver allowances to the government or pay a fine at the end of the scheme year is a liability. This liability arises as emissions are made. The liability is accounted for in accordance with IAS 37, Provisions, Contingent Liabilities and Contingent Assets. It is measured at the entity's best estimate of the expenditure required to settle the obligation in respect of the emissions made to date. The current market price of the number of allowances required to meet that obligation should be used to measure the liability, although the assessment of this market price may be complicated where companies intend to use different types of carbon instruments to meet their obligations. An expected shortfall in allowances available to meet the obligation should result in the recognition of a separate liability for the associated fine.

Income statement impact

The IFRIC 3 accounting requirements will result in timing differences in the income statement between the recognition of changes in value of the liability and of the intangible asset. The liability is revalued at each balance sheet date for changes in the market price of allowances. These changes are recognised immediately in the income statement. The same changes in the value of the allowances are not reflected in the accounting for the intangible asset if the cost model is followed unless the change in the value is an impairment. If the revaluation model is followed, the changes in value are recognised in the statement of changes in equity rather than in the income statement, again unless the movement is an impairment.

The impact of increases in the value of allowances is therefore not fully reflected in the income statement until the allowances are submitted to the government in satisfaction of the entity's obligations arising from emissions. This mismatch in accounting between the movements in the asset and the movements in the liability will increase income statement volatility.

Difficulties in application

The issue of allowances by governments to entities may occur after the start of the scheme year. This could delay the recognition of allowances and the corresponding deferred income by an entity until after it has started to emit greenhouse gases and recognise the associated liability. An entity should not recognise an intangible asset for the allowances that it will receive until it becomes legally entitled to receive those allowances. A delay in the recognition of the intangible asset and the corresponding deferred income will lead to a further mismatch in the accounting and additional volatility in the first few months of the scheme year.

Valuation of allowances on the introduction of the schemes may be difficult until active markets emerge. The use of valuation specialists is likely to be necessary at first.

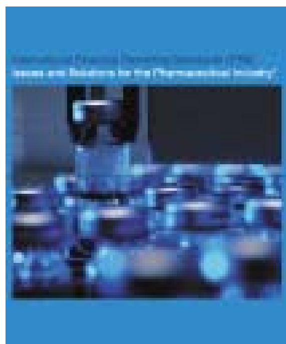
Other consequences

The introduction of an emissions scheme is likely to cause a reduction in expected cash flows from the CGUs that emit greenhouse gases. IFRIC 3 points out that this is an indictor of impairment under IAS 36. Affected CGUs therefore need to be tested for impairment as soon as reliable estimates of the impact of the emissions schemes can be made. This is likely to be a 2004 event for many entities.

Each national scheme will operate in a unique manner, driven by government policy. Liquid markets may emerge quickly in some countries, not at all in others. Management needs to understand how schemes work in each country where they have affected operations.

For more information about emissions trading, contact Richard Gledhill, PwC's global leader of climate change services, on +44 207 804 5026. Email: richard.gledhill@uk.pwc.com. Or contact your local climate change and emissions trading services team.

IFRS Issues and Solutions for the Pharmaceutical Industry



IFRS presents a number of challenges for the pharmaceutical sector. There are many publications that address the broader implications of IFRS, but none that consider the specific issues faced by the pharmaceutical industry. PwC's new publication highlights the hot topics that require consideration and presents the firm's view on the financial reporting solutions to commercial situations.

This publication provides solutions for a number of issues in the industry value chain. It will be updated as new issues and concerns arise following developments in the publication of the standards.

For copies of this publication, email marina.bello.valcarce@uk.pwc.com or call +44 (0)20 7212 8642.

Brand and brand extensions

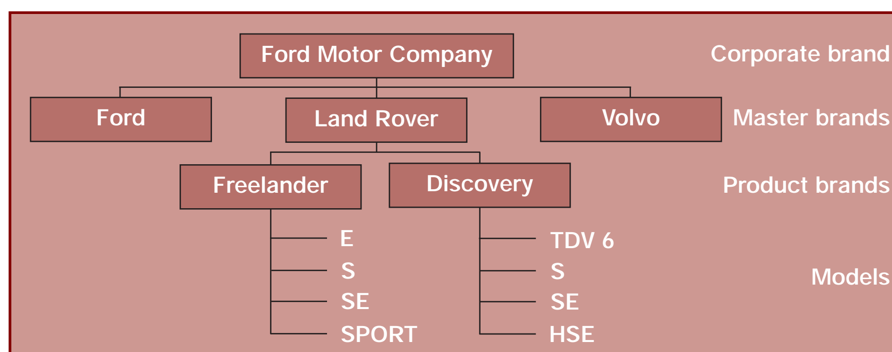
Understanding the relationships within a family of brands is crucial to identifying and measuring the individual assets and to assessing the impact of any potential impairment. Caroline Woodward explains.

Branded products often command premium prices from consumers. Launching a new brand is expensive and risky. A common strategy is to extend a successful brand to other products or services, known as brand extension.

This presents a number of challenges to any acquirer of the business that owns the brand or brands. Valuation at initial recognition needs to capture all of the brands (intangibles) acquired; corporate brand, master brands (or core brands) and brand extensions. The challenge is to avoid counting the same cash flows twice or more. All identified brands must then be given an appropriate useful life. The corporate and master brands may have an indefinite useful life; brand extensions are more likely to be finite. Impairment can be challenging – an impaired master brand will almost certainly mean extensions are impaired, but what about the impact of extensions on the master brand? This article provides some guidance.

Corporate brands, master brands and brand extensions

A master brand may or may not be closely related to a corporate brand. Contrast The Coca-Cola Company and Ford Motor Company with Diageo (*Johnnie Walker*) and Johnson & Johnson (*Tylenol*). A company will often have product brands in addition to its corporate and/or master brand. A brand extension is associated with and related to a core brand (master or corporate), for example, *Diet Coke*. A brand extension must be properly registered as a trademark in its own right to be recognised as a separate asset. For example, each of the five coloured labels of *Johnnie Walker* whisky is separately trademarked – *Red Label, Blue Label,* etc. Not all brand extensions are separately trademarked; for example, the decaffeinated version of a coffee brand or different flavours of soft drinks. Absent a separate trademark, there is no separate asset.



Identifying and measuring brands

One way to ensure that all brands are identified and recognised is to draw the brand family tree (see extract from Ford's in the box above). This provides a useful checklist and also assists in ensuring that the relationship between the corporate, master and product brands is understood. A distinct corporate brand may be an important component of the master and product brands but does not create value in its own right. It is not unusual to see entities value all the master and product brands and then to add a further amount for the corporate brand. This is wrong, as it overstates the corporate brand's value.

The key is to determine which brand drives the premium price and hence the increased cash flows. There is no 'one size fits all' analysis that can be done; however, it is useful to consider some examples. BMW might be at one end of the spectrum, where the BMW brand draws heavily on the Group's corporate brand; whereas the group's other brands, *Mini* and *Rolls Royce*, stand alone. The other end of the spectrum would be Diageo – all the company's master brands stand independent of the corporate brand.

Useful life considerations

A powerful consumer master brand like Coca-Cola is likely to have an indefinite useful life. Its brand extensions – for example, *Diet Coke, Cherry Coke, Vanilla Coke, Caffeine Free Coke and Diet Coke with Lemon* – may not. Normally a core, or master, brand will be well established before the extension is launched. Extending a brand to other products or services can be a way to extend the core brand's life as well as a means of increasing market share. Many core brands may be able to demonstrate the prospect of a long or even indefinite life. However, the same should not be assumed for its family members just because they have the benefit of a relationship with the core brand. Many brand extensions are created in response to changes in fashion or consumer tastes, which can be transitory. We can all think of product brands which no longer exist even though their core brand is still flourishing.

If a brand extension is to be attributed a separate value, it should be given the same scrutiny as any other brand to determine its likely useful life. How long does the brand owner expect to support it? Is the brand owner planning further extensions or even new brands that will deflect both management and consumer attention from the brand extension under review?

Impairment

Brands are impaired when consumers no longer attribute value to them. This can result from adverse events or publicity, such as a health scare. It may result from changes in fashion or in technology. Management can choose to withdraw a brand, effectively impairing it. The

impairment test needs to be applied to the right element of the brand family. Brand extension itself can create impairment concerns. The key risks are: failure of the brand extension, dilution of the core brand, and even damage to the core brand if things go badly wrong. The safest brand extension is a related product or service offered to the same market, although *New Coke* was an unsuccessful brand extension that damaged the core brand. The further from the existing product or service or its market the brand extension is positioned, the higher the risk of failure. Examples of failures that illustrate this point are *Harley Davidson Cologne* and *Levis Tailored Suits*.

The failure of a brand extension to meet management's expectations is usually clear, and the impact of the impairment indicator on the carrying value of the brand extension can be determined without difficulty. It is often less clear what impact an unsuccessful brand extension has had on the core brand. The family relationships are again important here, as the closer the relationship of the failed brand with the core brand, the more likely it is that the core brand has been damaged and possibly impaired. The failure of its cologne brand has hardly impacted the Harley Davidson brand but a problem with *New Coke* had serious implications for the main Coca-Cola brand. The failure of a brand extension or of one of the family members should always be considered an indicator of impairment for the core brand under IAS 36. The costs of repairing any related damage to reputation should be included in assessing the recoverable amount of the brand.

Conclusion

Brands are often major drivers of acquisition strategies and expansion plans. Understanding the relationships within a family of brands is crucial to identifying and measuring the individual assets and to assessing the impact of any potential impairment.

Interview

Developing the IASB brand

IASB Board member Jan Engström talks to IFRS News about the standard-setter's goals and his involvement in a number of IASB projects.

What experience do you bring to the IASB?

My background is in industry. I have worked for over 25 years in finance, and also as CEO for the world's second biggest producer of heavy buses. There are similarities between setting policies in a big company and setting standards, but of course standard-setting is more detailed and a great responsibility. I have a lot of respect for the knowledge of my colleagues and the standard-setting community.

I contribute my business experience and a pragmatic view from a preparer's perspective. The Board is a mix of backgrounds: some preparers; an academic; some users of financial statements, such as stockbrokers and analysts; and some members of the auditing profession.

What are you principle areas of involvement?

I am involved in a number of projects – some that I was allocated to, others I chose to be involved in myself. They include insurance and revenue recognition. I am also involved in establishing standards for small and medium-sized entities. It will make a big long-term difference if we can get SMEs worldwide to adopt a standardised view of how to manage financial reporting, and it will present opportunities too for broad-scale IT solutions. The potential of rationalising costs is also an important element in this project.

A main focus for me is Latin America [as IASB liaison member for the region]. I lived in Brazil for five years and have been travelling to the region for 25 years, so I speak the language and have contacts there. I also support my colleague Mr Tatsumi Yamada in China, and I am a contact for constituents in European industry. For obvious reasons, I also interact with the Scandinavian countries from time to time.

I am – as are all board members – involved in the projects for convergence with the FASB and with the Japanese standard-setter. The focus tends to be on the progress with US GAAP convergence. Japan has further to go, but it is an important capital market with significant companies, and we must work to make IFRS a truly global solution.

We also have a lot of interest in IFRS from China, India, Mexico, Brazil and Argentina. We need to support this. If you work in industry, you tell the subsidiary what you think and they do what has been agreed, but in a London-based organisation like ours to which no countries have a formal reporting responsibility, you can only support these countries, give them the arguments and try to convince them it's a good thing to become a member of the world community.

They are willing and can see the benefits, but there are traditions to overcome, little resources for change, implications for the tax situation, and perhaps a need for political decisions – it becomes complicated. You need to act in the country as an ambassador who can help push it forward. But being a member of

the IASB also opens a lot of doors. It's becoming a strong brand worldwide.

What is greatest challenge facing IASB in the future?

To achieve the second and third steps. The first step was finalisation of the stable platform and getting 100 countries on board. The second step is to continue the good progress with the FASB. With that, I believe we will see Canada follow. We hope to hear that companies using IFRS in 2007 will be accepted for SEC registration without reconciliation to US GAAP.

How will the IAS 39 carve-out affect this objective?

I would be surprised if companies don't implement IAS 39 as fully as possible in order to comply with IFRS and later with US standards, but we are working hard on a solution to avoid reconciliation issues arising from the carve-out.

It's sad that out of 2,000 pages of standards, there are 10 that are not valid. Let's hope that with time we'll find a solution. I'm an optimist.

There are a lot of different initiatives under way to resolve the IAS 39 carve-out problem. One is to come up with a substitute for IAS 39 in the long term. There are also discussions on short-term solutions in the hope of reaching an intermediate decision ahead of the bigger project.

What is Step 3?

The third step is to see the five big countries mentioned above – and of course many more – join in. To obtain global acceptance of IFRS we need to get not only Japan but also China, India, Mexico, Brazil and Argentina on board. Each country has its own challenges to overcome. For example, China has for a long time lived under a different economic system. We have had good discussions about pragmatic issues: how do you put a fair value on a financial instrument that is traded in both Hong Kong and Shanghai but with different prices? How do you consider the value of buildings and land, as land is in principle state-owned?

The Chinese authorities therefore need to define how they view certain things. They have attractive companies that interest foreign investors, and some Chinese companies would like to borrow money on international markets. A number of companies also have listings in Europe and the US so they are already using IFRS, US GAAP or both. But there is a tremendous need for education. There are around 12 million accountants in China and at least 12 million more managers who also need training in how to use financial information. So the state built three fantastic training facilities where around 6,000 pupils at once can attend courses. When China makes a decision to do something, it happens very quickly. But the system needs to mature; they'll get there.

Mexico has long had a strong position in accounting, and since the creation of a single standard-setter in Mexico – the CINIF – we have noted substantial progress. Mexico is now working hard to come as close as possible to IFRS. Many other countries work with the same ambitions and, to the extent possible, we try to support their work.

Is the IASB on track to achieve its objectives?

The Board and its staff are pleased that we've got where we are in a number of areas. In some minor areas we are disappointed that we have not achieved more – some projects have taken longer than expected.

The delays have partly occurred because of us focussing on the stable platform but also because it has taken longer than expected to take into account constituents' opinions. We don't want to rush the process. It's important that we stop and listen, and let everyone participate. So there have been some small deviations from achieving our objectives, but in broad terms we have been quite successful so far.

What do you hope to achieve personally in your remaining five years at the Board?

If we can achieve those second and third steps, it'll be a fantastic achievement. I'd also be happy if there was a broad consensus that IFRS has been good for everyone, increased values of companies and reduced the cost of borrowing, etc. Whenever there is change, it is very easy to step back and say, 'I like things as they are but I'm being forced to change, the change is bad'. So communication is an important part of our work.

I believe we are very much on the right track for the future – that's why my fellow board members and I work so hard for a truly global acceptance of IFRS, and of course for constant improvement in our standards.

Biography

Jan Engström was appointed to the IASB with effect from 1 May 2004. He is the liaison Board member for Latin America.

Jan worked with the Volvo Group for more than 30 years before joining the IASB, in various senior positions in his native Sweden and in Latin America:

- Volvo Bus Corporation: President and CEO 1998-2003;
- The Volvo Group: CFO 1993-1998 (responsible for financial reporting for a group with more than 200 companies operating in over 40 countries listed on European and US exchanges);
- Volvo Truck Corporation: CFO 1985-1993.
- Volvo do Brasil: CFO 1981-1985;

His term at the IASB expires 30 June 2009.

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