

IFRS News

Shedding light on the IASB's activities*

IFRS News – Issue 35
November 2005

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Issue of the month

IAS 27 includes de facto control

The IASB discussed the scope of IAS 27 and specifically de facto control at its recent meeting. Mary Dolson looks at this issue and the implications for IFRS preparers.

The IASB considered amending IAS 27R on the subject of de facto control at the October Board meeting. De facto control is a short-hand term that refers to an entity that consolidates another entity even though it owns less than 50% of the voting shares. Control does not arise in this circumstance from potential voting rights, by contract or by other means. Instead, control exists through an entity (the parent) holding and voting a large block of shares in the other entity (the subsidiary) in circumstances where the majority owners of voting shares are believed to be unable to coalesce to successfully vote against the wishes of the parent.

Example

Company A owns 48% of Company B, which is listed. The other shareholders of Company B are widely dispersed, and historically no more than 30% have been active at general meetings, where Company A's vote has recently prevailed.

Management of Company A may assert it has de facto control over Company B. The assertion would need to be evaluated against many factors, including the legal and regulatory environment, the nature of the capital market where B is listed and the ability of the majority owners of voting shares to vote together.

The Board decided not to amend IAS 27 but released instead a statement explaining the Board's understanding of the standard. It stated that IAS 27R includes the concept of de facto control, despite the specific requirement that consolidation takes place when one party holds a majority of the voting rights. The Board also acknowledged that the standard is not clear and that guidance could have been included to enable readers to understand this principle. No changes are currently planned to IAS 27R pending the conclusions of the ongoing control project. An exposure draft from the control project is not expected before Q4, 2006. The Board recognised that different treatments might persist without further guidance and because of practices followed by first-time adopters under their previous GAAP.

Some observers have asked what authority is associated with a press release or statement from the Board. Due process for the issuance of standards and interpretations is set out in the preface to IFRS. It does not indicate what authority should be given to statements issued by the Board. The auditing standards in the US contain an explicit hierarchy to be followed when applying US GAAP, with the issued standards of the FASB and its predecessor bodies as the most authoritative. The hierarchy has five official levels including

(on the fourth level) Q&As published by the FASB staff and (on the fifth and lowest level) other accounting literature including textbooks, handbooks and articles. Notably, the rules and interpretations of the SEC are generally given the same standing as the issued standards. Where there is an absence of explicit IASB guidance, some regulators may seek to enforce a specific interpretation in their jurisdiction.

The Board's view that de facto control is appropriate is consistent with previous requirements under some national GAAPs, and its EU equivalent 'dominant influence' remains in the 7th EU directive. Management should take these factors and others into consideration when the existence of control is assessed. The Board has not amended IAS 27; it has stated that judgement is required to determine whether de facto control exists and no guidance has been provided.

Implications for existing preparers

Management may want to review their detailed accounting policy that defines

what subsidiaries are, in particular how 'control' is assessed, in light of the Board's statement that the concept of control might include more than legal ownership of shares and potential voting rights. Management may decide that the re-consideration of their accounting policy does not result in any change in their subsidiaries or the scope of consolidation.

A company that reviews its consolidation policy and concludes that additional subsidiaries should be consolidated should properly account for the additional subsidiaries. Consolidation accounting should be applied retrospectively back to the date that control was achieved. A business combination that occurred on the date that the de facto control is deemed to have been obtained must be accounted for under the appropriate accounting standards (IAS 22 up until the adoption of IFRS 3).

Implications for first-time adopters

First-time adopters may want to review their detailed accounting policy on

consolidation. Most 2005 first-time adopters have published opening balance sheets and interim financial statements. However, a decision to consolidate based on de facto control is the policy adopted in the company's first IFRS financial statements and is not a change in accounting policy under IAS 8. A first-time adopter that did not previously consolidate a subsidiary where de facto control exists could take advantage of the business combinations exemption in IFRS 1 and use the provisions contained in paragraph B2(j) of that standard. First-time adopters should also consider the views of their primary, and any secondary, regulator when concluding on de facto control policies.

Conclusion

Companies need to be aware of IASB statement on consolidation but should also remember that the Board has acknowledged that there might be divergent practice in this area.

Financial guarantee contracts



Accounting for financial guarantees – IAS 39 or IFRS 4?

Kevin Klein and Jeanine Schembri look at the recent IASB guidance on accounting for financial guarantees.



The IASB amended the guidance for the treatment of financial guarantee contracts in August. The objective of the amendment is to ensure that issuers of financial guarantee contracts recognise the impact in their financial statements. Issuers must apply the new guidance for annual periods beginning on or after 1 January 2006; earlier application is encouraged.

The new guidance clarifies when a financial guarantee contract is accounted for under IAS 39, Financial Instruments: Recognition and Measurement, and when under IFRS 4, Insurance Contracts.

All guarantee contracts are accounted for under IAS 39 unless the issuer has previously asserted explicitly (eg, in its financial statements or submissions to regulators) that it regards the contracts in question as insurance contracts and has applied the accounting treatment specifically applicable to insurance contracts. The issuer has a choice of applying IFRS 4 or IAS 39 for guarantee contracts that meet these two tests.

One effect of the amendments is that the accounting for financial guarantees will reflect the entity's business model. In

particular, credit insurers will retain most aspects of their existing accounting, and non-insurers are not required to apply the requirements and disclosures of an insurance standard.

The accounting treatment of a financial guarantee contract by the holder remains outside the scope of IAS 39 and IFRS 4.

Definition of a financial guarantee contract

The following definition of a financial guarantee contract, which is currently

included in IFRS 4, has been added to paragraph 9 of IAS 39: ‘A contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument’.

Financial guarantee contracts comprise three parties:

- the issuer of the financial guarantee,
- the holder of the financial guarantee, and
- a specified debtor.

Instruments with various legal forms will meet this definition, including credit guarantees, some types of letters of credit, credit default contracts and credit insurance contracts.

Not all types of guarantee contract will meet this definition. The key question is whether the contract requires payments even if the holder has not incurred a loss on the failure of the debtor to make payments when due. A contract that requires payments in response to changes in a specified credit rating, for example, is a derivative contract that must be recognised and measured at fair value under IAS 39.

Accounting treatment

The accounting treatment and disclosure requirements differ depending on whether IAS 39 or IFRS 4 is applied, as summarised in the table below. An issuer could apply the fair value option to those financial guarantee contracts to which IAS 39 is applied, provided the IAS 39 conditions are met.

Intra-group guarantees

The amendment does not provide an exemption for intra-group financial guarantees; for example, a guarantee issued by a parent to one of its subsidiaries. The accounting treatment described above is applicable for the issuer’s stand-alone financial statements.

Practical difficulties may arise in measuring the fair value of such intra-group financial guarantees. It is common either for no fee to be charged, or for the fee not to be on arm’s length terms and hence not to reflect the fair value of the financial guarantee. The issuer is required to determine the fee that would be charged for the guarantee in an arm’s length, market transaction. When a parent company gives a financial

guarantee for less than its fair value (including where it charges no fee), the difference between the amount charged and fair value is a capital contribution.

This treatment of intra-group guarantees under IFRS is different from US GAAP, which excludes intra-group guarantees from the scope of FIN 45, Guarantor’s Accounting and Disclosure Requirements for Guarantees, Including Indirect Guarantees of Indebtedness of Others.

Accounting treatment for the holder of a financial guarantee

The accounting treatment for the holder of a financial guarantee contract is outside the scope of IAS 39 and IFRS 4.

The holder of a financial guarantee has two elements to account for: the premium paid and payments received under the contract. The premium paid is recognised as an asset in the balance sheet and amortised over the life of the guarantee contract. Payments (and potential payments) that become due because the specified debtor fails to make payment when due are taken into account when determining the amount of any impairment of the holder’s receivable from the debtor.

	IAS 39 treatment	IFRS 4 treatment
Initial measurement	Fair value (normally consideration received).	Apply the liability adequacy test** (consider current estimates of all future cash flows under the contract).
Subsequent measurement	Higher of: (i) the amount determined in accordance with IAS 37*; and (ii) the amount initially recognised less, when appropriate, cumulative amortisation recognised in accordance with IAS 18.	Apply the liability adequacy test.
Disclosure	Apply IAS 32/IFRS 7	Apply IFRS 4

* IAS 37 is based on the ‘best estimate’ of the expenditure required to settle the present obligation. Discounting is required.

** Discounting is not mandatory under IFRS 4.



Share-based payments – key differences between IFRS and US GAAP

Marie Kling, in the next few editions of *IFRS News*, describes the differences between US GAAP and IFRS in a number of accounting areas, as discussed by the firm's IFRS Working Group (IWG). This first article focuses on share-based payments.

The IASB and the FASB have achieved convergence of IFRS 2 and FAS 123R in principle (except for the related tax accounting). As always, the devil is in the detail. Differences arise in the application of the standards in the areas of scope, definition of key terms, classification of awards as liability or equity, attribution period, modifications of awards, cash flow statement presentation and valuation.

Entities that report under both IFRS and US GAAP need to understand the differences in between IFRS 2 and FAS 123R. Management may want to design benefit plans that produce the same accounting results under both frameworks, to the extent possible. Users of financial statements need to understand why certain share-based arrangements may produce different accounting under IFRS and US GAAP.

Practical and business implications?

The application of IFRS 2 may result in a different amount of compensation expense being recognised compared to FAS 123R because of a differing measurement or attribution method. This may result in a reconciling item between IFRS and US GAAP for foreign private issuers, and the need to separately track and measure share-based payment awards. The examples below illustrate how differences might arise.

Definition of grant date

Grant date may occur earlier under IFRS 2 than under FAS 123R. This results in a different measurement date and recognition of different amounts of compensation expense.

Example

Employees are eligible for a specified formula-based bonus award measured over year 1. At the end of year 1, employees are able to elect to take the bonus in the form of shares rather than cash. The shares are valued at the share price at the end of the year.

- FAS 123R: the grant date will not occur until the shares are received at the end of year 1, as employees do not benefit from, and are not adversely affected by, movements in share price until that date.
- IFRS 2: the grant date would be at the beginning of year 1, if the basis for determining the bonus is well-defined.

Classification of share awards redeemable at fair value

Certain awards with put features have to be classified as a liability under IFRS 2, with mark to market accounting for the liability. These may be classified as equity under FAS 123R with no mark to market, and therefore less income statement volatility.

Example

A company grants restricted shares that may be put to the company for the shares' fair value at the repurchase date after the employee has held them for more than six months after being vested.

- FAS 123R: the puttable shares are classified as equity (or mezzanine equity), and would not subsequently be remeasured.
- IFRS 2: the puttable shares are classified as a liability and marked to market every period.

Implications for convergence?

Convergence on high-level principles has meant that many aspects of accounting for share-based payments have been converged. However, results may differ due to differences in the application of the principles.

IFRS Working Group

PwC has created an IFRS Working Group that brings together 12 to 15 partners working on IFRS issues in various technical and client service teams in the US and globally. Marie Kling who heads up this group talks about its objectives and agenda.

What does the IWG do?

The IWG focuses on matters important to clients. Its mission is to support IFRS client needs in the US; ensure identification, consistent treatment and knowledge-sharing on key IFRS and US GAAP accounting and regulatory issues; and develop global PwC views on similarities and differences between IFRS and US GAAP.

What is on the agenda?

The IWG has so far focused on the practical issues facing our clients in the key areas of share-based payments and employer-provided benefits. We are now looking at financial instruments, with an emphasis on hedging and embedded derivatives. Articles on our analysis of all these topics will feature in future editions of *IFRS News*.

The future priorities of the IASB

IASB chairman Sir David Tweedie talks to IFRS News in the first of a two-part interview, originally broadcast at PwC's 'IFRS 2005' conference.

Is IFRS becoming too complex?

Part of the problem is that we inherited a set of standards, and some of the complex standards were in that set, such as IAS 39. Since then we have been trying to simplify them. The arguments have really been over the old standards, not what we've done since we were established in 2001.

We can write simpler standards, but they'll be tougher. People mustn't keep saying, 'What do I do in this situation, and what do I do in that situation?' That's what leads to complexity and exceptions. If you want exceptions, you have to ring-fence them. IAS 39 is full of scope carve-outs and so on, and that's why it's so complicated. Now that the rush for 2005 is over, we can take our time.

Will IFRIC have time to deal with all the issues that it delegates to other national interpreting bodies?

We're back to the question of rules versus principles. If you want principles, you'll have to think of the answer yourself. Why do we have to answer all these questions? Can't people make judgements? If we answer a lot of the questions, we are going to get an absolute rule book.

IFRIC is doing very well in turning questions down, advising that the answer is obvious or in the standard. If the standard is ambiguous, we've suggested that IFRIC draft a different paragraph that is clearer, and we should change the standard. If there's something that's an abuse, clearly we'll have to step in.

We've said that we'll deal only with international issues. If there's something specific to France or Australia, for example, that's up to the national bodies. But often somebody else has got that issue too. We'll find that these are being treated all around the world in different ways, and that's hopeless.

We suggest that the national standard setters come to IFRIC with an answer to

a given problem. We then find out whether it's an international issue, or whether it's something specific to French law or Australian law, for example, and

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deal with it that way. We limit the interpretations quite deliberately.

Does the IASB support the ARC's proposal to form a roundtable of a range of stakeholders to deal with the consistent application and enforcement of IFRS in the EU?

The ARC is trying to provide a 'filter' so that they can knock out a lot of the issues that come to IFRIC in the first place. We have to be careful that we don't have a 'European Interpretations Committee'. You must only have one interpretation body if you want uniform standards. The minute you start interpreting differently, you get regional standards, and that'll be a big mistake. The filter idea is a good one, but if it puts out proposals and interpretations, we have a problem. As long as it sticks to helping IFRIC to decide what is important, it'll be very useful.

Is convergence an alignment of IFRS with US GAAP?

The US is also complaining about the changes that they're making to take our standards. They've looked at expensing share options. They would never have done that if we hadn't done it. They're amending voluntary changes accounting policies to the international way. This is causing restatements, which they don't like in the US. How will they exchange

assets? By using our methods. They're also looking at whether they should revalue investment properties. Should they capitalise development costs? Should they bring subsequent events into the accounting literature? They are also looking at the fair value option.

It isn't all 'one way'. We asked our international analysts' group which accounting treatment they preferred for segments. They said the US way. Companies don't like the IFRS method either, because it means they've got to do some things differently from the way they deal with it internally. That's why we're moving to the US approach. Deferred taxes? We're changing bits, they're changing bits. I'd like to change the entire standard, frankly, but the standards are there. We're making sure they all come together.

I think it's very much a two-sided partnership. When we move on to the

On principles: Why do we have to answer all these questions? Can't people make judgements? If we answer a lot of the questions, we are going to get an absolute rule book.

future and we start writing joint standards, you'll see that the US way of doing things isn't going to be the one that prevails.

Do you think that, by including US-specific guidance in IFRS and preparing joint projects, IFRS will become more rules-based?

We are currently discussing the question of principles versus rules. What I would like to see is much shorter standards, starting off with an objective, which is the main principle. For example, the leasing standards have converged internationally, but none of them work.

One possibility, if we were to have a leasing standard with the first principle that you are required to show the liability you've incurred by signing the lease contract, and the rights to the asset you've obtained thereby, which will be the same number, what more do you want? That's the standard! And it's principle-based. You want to know about renewal options and what to do about guaranteed residuals, but how much do I have to tell you? Do we have to deal with all the little changes people make in lease contracts? Basically, you have to show the liability and the asset, and that's it. We don't need lots of anti-avoidance stuff – if you haven't shown the liability, you've failed and your accounts should be qualified.

On regulators: We're telling them that if they want preparers to use their own judgment, they can't second-guess them.

We pointed out to the SEC that if they mean what they say in calling for principle-based standards, they cannot say to a company, 'You've used your judgment, and that's one way you can achieve the principle's aim, but we want you to do it another way'. That's not acceptable. We're telling the regulators that if they want preparers to use their own judgment, they can't second-guess them.

We've mentioned to IOSCO that this is going to be a key way of preparing accounts. Are we going to give the judgment to the CFOs and the auditors, or is it going to remain a rule-based system with the regulators and the standard-setters enforcing it? The real question then is, can the CFOs and the auditors stop asking us questions? The securities regulators say that all the CEOs of the financial institutions want principles; their compliance officers want answers to particular questions. Which way do we go? The profession will get the standards it deserves. The new standards are going to shape the way the profession goes in the future.

Preparers have undergone great changes to embed IFRS. The IASB is still changing the standards. Is it time for stability?

There are two issues here. One is that 2005 is over as far as standard-setting is concerned. We changed 17 of the existing 34 standards and issued another seven. That pace of change can't go on. We have a few convergence issues ahead of us. Some can be done relatively quickly, such as the possible capitalisation of borrowing costs, and possibly knocking out the expensing option.

Then there's the roadmap that EU Commissioner McCreevy and SEC Chairman Donaldson were talking about. We've been working with the FASB for at least six months on that. We're getting to the stage where we would like to send it to the SEC and the European Commission and propose to get rid of the reconciliation with US GAAP. The SEC says is that it has accepted our argument. We propose to get rid of reconciliation by the end of 2007 or early 2008.

We're trying to proceed as follows: where we have a standard that's in need of improvement – such as IAS 39 or FAS 133

On convergence: You'll see that the US way of doing things isn't going to be the one that prevails.

– let's create a new one. The SEC has indicated that there are about 11 subjects like this. It's clear that US and international standards are going to come together, so once we've achieved the targets set out in the road map, the SEC should accept our standards in the interim without reconciliation. That's our aim.

When you look at the standards in question (consolidations, financial instruments, derecognition, leasing, pensions), these are huge areas. We're not going to rattle through these in a few months. I don't think you'll be seeing more than one or two new standards a year now.

Then in the meantime there are the problems with IAS 39. We could keep amending IAS 39 from now till doomsday, but we have to stop; we want to move on to a new standard.

What about Business Combinations 2?

There are several controversial things about this standard – the treatment of

On BC2: It won't be quick; it's going to take 18 months, at least, from exposure, if we don't re-expose it.

minority interests, step acquisitions, the full goodwill method – but it's an exposure draft. Let's see what other people think. There is also division within the Board. It won't be quick; it's going to take 18 months, at least, from exposure, if we don't re-expose it.

Is it acceptable to have amendments to disturb the markets during their preparation of IFRS 2005?

BC was always going to be an ongoing project. We said at the beginning that we'd first do half of it, and then the rest. That was what we were asked to do. People were concerned that the US standard gave US companies a massive advantage over everybody else. But we just looked at the big bits: goodwill impairment, no pooling and how to deal with intangibles. Then came all the other areas where we differ from the US.

We have to look at whether people will accept these big changes. Can we deal with the situation of how to sell shares in a subsidiary with no gains and losses being shown unless you lose control? How do we deal with minority interests as part of equity, the full goodwill method? We asked the analysts if this helped or if it was a waste of time, in which case the costs are there, but no benefit. We want to hear people's views on these questions.

Energy and utilities – IFRS roundtable

First-time adopters of IFRS from the energy and utilities sector got together last month to exchange views on the key issues that they face in preparing their first set of IFRS financial statements. The roundtable, held in London, was attended by around 50 representatives from 22 companies in the sector, including E.ON, RWE, Centrica, Repsol, Total, Shell, ENI and Statoil. Around 30 employees and partners from PwC also attended.

The first half of the day was taken up by a plenary session covering emission rights, IFRIC 4, income statement presentation, and the IASB extractive industries group.

The afternoon comprised two break-out sessions covering oil and gas issues and utilities issues. The oil and gas hot topics were: IFRS 6; overlift and underlift; revenue; problem areas in jointly controlled assets, operations and entities; impairment

and cash-generating units; and reconciling items for SEC filers.

Utility-specific issues on the agenda were: IAS 39; cash-generating units; and the component approach.

PwC's EU&M group will be releasing a white paper on IFRS issues facing the sector in the next few weeks. Contact olesya.hatop@de.pwc.com for more information.

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