

IFRS News

Shedding light on the IASB's activities*

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Issue of the month

ED on financial instruments puttable at fair value

Jeanine Pickering and Sandra Thompson look at the principle requirements of the IASB's new exposure draft.

The IASB published proposals last month to improve the financial reporting of particular types of financial instruments that have characteristics similar to ordinary shares but that are currently classified as financial liabilities.

The financial instruments in question are:

- instruments puttable at fair value;
- instruments with obligations payable on liquidation, for which liquidation is certain (this affects limited-life entities); and
- instruments with obligations payable on liquidation, for which liquidation is at the option of the holder (this affects partnership interests).

Example of unexpected accounting under current requirements

Members of a dairy co-operative called Milky Milky are all dairy farmers. Each member purchases shares in Milky Milky at fair value; the shares entitle the farmers to sell a specified amount of produce via the co-operative. A dairy farmer will acquire sufficient shares to reflect the amount of produce it wants to sell via Milky Milky. When a member chooses to reduce the amount of produce it sells via the co-operative, it must put the shares back to Milky Milky for a pro rata share of its fair value.

Shares of 25 have been issued to members by the end of year 1. The proceeds are invested in tangible assets (20) and cash (5).

The co-operative increases its cash balance to 10 and creates 10 of internally generated brand names and goodwill in year 2. The brand name and goodwill are not recognised on the balance sheet. Members can put back their shares; the co-operative must therefore account for the shares as a liability measured at the appropriate share of the fair value of the entity. This value includes the internally generated goodwill and brand names. Milky Milky, a successful business, produces the unexpected result of a negative net asset position. Furthermore, a loss is recognised in the income statement when the liability for puttable shares increases because of the co-operative's success.

Similar issues apply to partnerships that are required to liquidate upon the exit of a partner (for example, retirement or death) and also to limited life entities.

Co-operative balance sheet – Year 1		Co-operative balance sheet – Year 2	
– assets		– assets	
– goodwill	0	– goodwill (not booked under IFRS)	0
– tangible assets	20	– tangible assets	20
– cash generated	5	– cash generated	10
Liabilities		Liabilities	
Instruments held by members	(25)	Instruments held by members (implicitly includes a year of goodwill)	(40)
Net assets	<u>0</u>	Net assets	<u>(10)</u>

ED proposals

The Board proposes to address this problem with the following exemption to the definition of a financial liability. The terms in bold are explained below.

A contractual obligation does not include:

- an obligation to redeem or repurchase a financial instrument puttable at fair value, provided that all financial instruments in the **most subordinated** class of instruments with a claim to the assets of the entity are financial instruments puttable **at fair** value; or
- an obligation to deliver to another entity a **pro rata share of the net assets** of the entity upon its liquidation, provided that all financial instruments in the **most subordinated** class of instruments with a claim to the assets of the entity impose such an obligation.

Most subordinated means that the amount paid on liquidation is after all others claims are paid out.

Fair value is determined using IAS 39 guidance (IAS32.48A and AG 69-AG82). Formula-based methods of fair valuing are permitted only where the formula is intended to approximate fair value. It applies only to those entities whose securities are not publicly traded or that do not hold assets in a fiduciary capacity for a broad group of outsiders.

Pro rata share of the net assets means that the financial instrument's right to the entity's net assets is neither limited nor guaranteed.

Other important issues

Minority interests in a subsidiary that are puttable at fair value would not be classified as equity in the group's financial statements because such minority interests are not in the most subordinated class of instruments. These types of minority interests would

therefore continue to be classified as financial liabilities in the consolidated financial statements.

Warrants (and other derivatives) to be settled by the issue of financial instruments puttable at fair value are excluded from equity classification and continue to be classified as financial liabilities. The objective of the proposed amendment is to improve the financial reporting of financial instruments that have characteristics similar to ordinary shares. Warrants do not have characteristics similar to ordinary shares.

The classification of the pre-existing instrument should be reassessed if another class of financial instrument is issued that is 'more subordinate' than the instrument in question.

Additional disclosures are proposed in the exposure draft. They relate to:

- Reclassifications between liabilities and equity;
- Fair value;
- Quantitative data about the amount classified as equity; and
- How the entity manages its obligation to redeem the instruments when required to do so by the instrument holders.

Instrument	Present classification under	Classification under proposed
	IAS 32	amendments
Ordinary share/partnership interest puttable at fair value	Liability	Equity
Ordinary share puttable at fixed amount	Liability	Liability
Warrant over ordinary share puttable at fair value	Liability	Liability
Preference shares puttable at fair value	Liability	Liability
Ordinary share in a limited-life entity	Liability	Equity
Warrant over ordinary share in a limited-life entity	Liability	Liability
Non-redeemable preference share in a limited-life entity	Liability	Liability
Ordinary share puttable at fair value issued by a limited-life entity	Liability	Equity
Partnership interest in a partnership that automatically liquidates upon exit of partner	Liability	Equity
Partner's right to be repaid a specified amount of contributed capital upon exit of partner	Liability	Liability
Ordinary shares of subsidiary, puttable at fair value to the subsidiary, some of which are held by third parties	Sub: Liability Group: Liability	Sub: Liability Group: Liability
Minority interest in common shares of a limited-life subsidiary	Sub: Liability Group: Liability	Sub: Liability Group: Liability

From 'crunch time' to 'real time'

Mark King and Michael Stewart look at the issues discussed at the PwC's Energy & Utilities (E&U) IFRS roundtable and the launch of the publication *Real Time*, which looks at how IFRS is being applied in practice in E&U companies.



IFRS has had significant impact on financial reporting for many E&U companies. PwC's publication *Crunch Time* in September 2003 highlighted a number of challenges that we foresaw in the transition to IFRS by companies in the E&U industries. Many of those E&U companies that transitioned to IFRS during 2005 are now at the end of the first IFRS reporting cycle. To mark this milestone, we have published *Real Time*.

Real Time looks across the value chain of each industry and discusses in detail how the new IFRSs are being applied in practice. The publication takes a three-pronged approach to these issues. It provides:

- analysis of each issue and a commentary on the accounting treatment under IFRS;
- practical examples of the issues faced, together with a solution for how to address them; and
- extracts from published financial statements, presented as examples of the policies applied by some of the 2005 first-time adopters.

Hot topics for the industry

Real Time was launched in May at a client roundtable in London. The guest speaker was Bob Garnett, IASB member and IFRIC chairman, who spoke about the Board's Extractive Industries Working Group. He also gave an update of the progress on convergence between IFRS and US GAAP. Over 40 people from 19 energy and utility companies attended the event.

Other sessions included an account of **experiences of the 2005 reporting season**, which considered the

achievements of companies that made the transition, set against the scale of the task. This session also considered the **expectations of consistency** in application of IFRS in the context of principles-based standards. It touched on the inevitable pressure that arises on auditors to create 'rules' in order to drive consistency.

Two sessions focused separately on issues specific to the oil and gas industry and the utilities industry. The utilities breakout session devoted significant attention to **financial instruments** issues and **IFRIC 4**. Two of the key issues considered in the oil and gas breakout session were accounting for **business combinations** in the upstream sector and the difficulties in dealing with **joint ventures**.

Upstream business combinations are subject to the same accounting guidance as business combinations in any other industry; however, goodwill was not recognised under many national GAAPs. IFRS 3 requires all assets and liabilities acquired to be recognised at fair value – one of the key assets will be the reserves acquired. The difference between the fair value of the assets and liabilities acquired and the consideration paid will be goodwill – but it is important for management to understand the value drivers behind the goodwill. These might be synergies between the acquired fields and the acquirer's existing properties; or the goodwill might arise from intangible assets that are not permitted to be recognised separately, such as the value of an assembled workforce.

The accounting for and rationalisation of goodwill is complicated further under IFRS by the accounting for deferred tax. Recognition of deferred tax liabilities in a business combination results in a corresponding increase in goodwill. This

can have a more significant impact in the oil and gas industry than many others because of the relatively low values of goodwill that are otherwise recognised and the high total tax rates that often apply to oil and gas production – as high as 80% in some countries.

Joint ventures and other similar arrangements are pervasive to the energy industry. The high-risk environment of oil and gas exploration has led to many joint venture-type arrangements being used to share risk and returns. The significant capital investment required for midstream and downstream infrastructure has also led to the proliferation of risk- and cost-sharing arrangements between entities. IFRS provides clear guidance on how to account for the various different arrangements when the definition of joint control is met. However, the guidance is not clear where arrangements do not meet the technical definition of joint control.

Problems arise when ownership of assets is held directly by more than one entity and where consensus decision-making is employed for using the assets but without the requirement of unanimous agreement. This is an area being considered by the Board, but no firm decisions have yet been taken. The general direction in which discussions have gone so far is for entities to account for the rights they control unilaterally, probably as intangible or financial assets, and to recognise their associated obligations as liabilities.

Visit www.pwc.com/energy to download *Real Time*. Contact mark.king@uk.pwc.com and norbert.schwieters@de.pwc.com for further information.

IFRS: one world, different views

Klaus-Dieter Steinfels, Olivier Scherer and Shelley So were seconded to PwC's Global Accounting Consulting Services group last year from France, Germany and China respectively. These three partners have different backgrounds and widely varying experiences in IFRS financial reporting. They give *IFRS News* their perspectives.

What were your roles in your home countries before you came to Global ACS?

DS

Most recently I was a partner based in Essen, working in risk management and quality assurance. As a QA partner I was responsible for reviewing the IFRS financial statements of major listed companies. I also consulted on German GAAP and IFRS issues in close cooperation with the German IFRS technical department.

Before that I was client relationship partner for Deutsche Post and its subsidiaries. I had already been responsible for the group when it became a limited company and prepared its IPO. I have also been engagement partner for a number of other large German groups.

In addition to my responsibilities at PwC, I was a part-time lecturer at the University for Applied Sciences in Bochum and had roles at the German Institute of Chartered Accountants.

OS

I was in PwC's Global Capital Markets Group in Paris, primarily working on IFRS conversion projects. I had close

connections with the French technical group. Most of my clients were large listed companies such as France Telecom, Sodexo, Axa and La Poste.

SS

I was based in the Energy and Utilities group in Beijing, working mainly on IPOs and audits of state-owned enterprises (SOEs). My clients included Beijing Datang (power generation), Chalco (aluminium) and China Coal. I also did IPO projects with companies in other sectors, such as China COSCO (shipping) and China Life (life insurance). These state-owned enterprises (SOEs) tend to be huge entities.

Why have you come here?

DS

Global ACS wanted a German partner on board. I was flattered to be asked. The group has a high level of expertise. To work in close cooperation with these experts is a great challenge and an excellent chance to further develop my IFRS know-how.

As a member of the revenue and liabilities team, I am able to contribute my tax expertise. I have been a tax partner for 11 years and was chairman of the indirect tax working party of the

German Institute. I was also a member of the indirect tax working group at the Fédération des Experts Européens Comptables.

OS

While working on IFRS conversion projects, I quickly realised our clients' need for two things: high-level expertise in IFRS; and easy access to this expertise by being able to meet in person those with the right skills. Joining Global ACS is a means to develop unique skills that help to better serve our clients.

SS

Most of our SOE clients have to prepare financial statements using IFRS or Hong Kong IFRS (which converged with IFRS in 2005). China will also converge with IFRS, in 2007. A solid knowledge in IFRS is therefore very important to us. I was keen to learn more about the standards and have a global view. Most of the issues I am dealing with now are new to me (I am based within the business combinations team), but they are likely to arise in China as the market continues to develop. So what I am learning here will be very useful for me in the future. It is also great to have the opportunity to work with and learn from the best technical experts.

Biography – Klaus-Dieter Steinfels

- PhD in economics, University-Ruhr – 1977
- Joined PwC, Essen office – 1977
- CPA in Germany – 1984
- Became partner – 1989
- Consulting and risk management partner for audit and accounting (Essen, Dortmund and Recklinghausen offices) – 2000
- Part-time lecturer at University Applied Sciences of Bochum
- Quality assurance partner (Essen and Recklinghausen offices) – 2004
- Member of board of examiners for CPAs at the German Chamber of CPAs
- Seconded to the Global ACS Central team – October 2005



What were the big issues facing companies in your territory? Is the work you do in Global ACS very different from back home?

DS

In Germany, I wrote IFRS solutions – in cooperation with our local IFRS technical department – to issues relating to leases, deferred tax, and liabilities versus equity. Other important issues for German companies are financial instruments, specifically hedge accounting. Emission rights is also a big issue for our large energy companies.

The questions I dealt with arose during the audit process – some were routine, others were more challenging and needed to be referred up to Global ACS. Most of the questions I deal with here in Global ACS are subject to controversial discussions.

OS

The big issues for me revolved around getting clients to understand that transition to IFRS requires a change in mindset and that it is more complicated than it looks. Having the client accept this is a big win and allows everything that follows to go more smoothly. We then had to implement these changes, starting at the lowest level. It's quite easy to deal with an impairment charge, for example, at corporate level relating to a big business. But when it is a question of changing the whole revenue recognition process at the lowest subsidiary level, there are lots of implementation issues, including training, writing accounting manuals, looking at which other contracts will be impacted, changing

systems, etc. There is a huge amount of work that is not always anticipated.

Within Global ACS, however, we do not deal with process issues but technical resolutions. These are two very different challenges. I need the experience at a technical level, because you cannot implement the principle if you don't understand the basis for that principle.

The technical issues I handled before varied according to industry. In telecoms they tended to be revenue recognition, impairment, intangibles and the component approach to IAS 16.

SS

I was working with SOEs on IPOs in my home country. SOEs have many common issues. The first critical accounting issue for these companies during IPOs is IFRS convergence. Most of their finance people have only limited IFRS knowledge and so the education process is really tough. IAS 24, Related Party Transactions, is also an issue in China. All SOEs are supposedly related parties, but most do not have well defined legal structures for their subsidiaries. Identifying which are their related parties can be a real challenge – many have hundreds of subsidiaries all over the country. Unless they have a system in place for gathering this information, it is difficult to apply.

Other hot topics back home are IAS 39 and basis of preparation (as all SOEs have to undergo reorganisation before IPOs). There is also convergence of Chinese standards with IFRS, which brings a lot of practical difficulties. There

not always sufficient understanding of the subtleties of IFRS by the professionals. People are used to detailed guidelines and have not had to think about the substance of transactions as you have to under IFRS. When they do not understand how to implement the standard, they request guidance. The guidance they are given may result in a deviation from the standard itself during implementation. We're some way from full convergence.

The pace of the work for me in Beijing was very different from here. IPO projects are year-on-year, working with only a few clients at any one time. I had time to discuss the issues and monitor the progress. Asia is renowned for its long-hours culture. It was quite normal for me to work until 11.00pm, and sometimes even overnight. It is also quite normal for us to work six or seven days a week. Here, on the other hand, people respect your personal life and also strive for a work/life balance. The pressure here is no less intense, but it is different. People always need a quick answer but may not have all the information for you in a timely way. They are under pressure from clients, but because the issues are usually quite complicated, we have to cross-consult a lot before we come to a final answer. So although the working day is shorter, the work is compacted into that day.

What are the key lessons you have learned so far from the group?

DS

I did not expect Global ACS to be so international. Other members come from

Biography – Olivier Scherer

- Business school, major in finance – 1992
- Chartered certified accountant in France – 1998
- CPA in California – 2001
- French auditing firm, Paris – 1992
- PwC Strasbourg office, audit – 1995
- PwC Dallas office, audit (TICE) – 1998
- PwC San Jose office, audit (technology) – 2000
- PwC Paris office, Global Capital Markets Group – 2002
- Seconded to the Global ACS Central team – October 2005



all around the world, which broadens the view and widens the debate. It also means you get to learn new ways of thinking and to be more tolerant. Everyone helps each other to get a high-quality output.

I have wide experience networking so I realise how important this is to providing good services to our clients and for building up Global ACS as a broader and more stable network. I expect this will strengthen the knowledge base and expertise by involving more knowledgeable and experienced people in the decision-making process.

OS

In the past, when each territory was applying its own GAAP, no one needed to be concerned about what other countries were doing, so it was easier to come up with local answers to tricky accounting questions. With IFRS, we need consistency throughout the firm, and our new Global ACS structure helps us to achieve that objective. It involves a

lot more discussion with various territories but is also much more rewarding for everyone. Obtaining consensus among various territories can sometimes be challenging. We face language issues, cultural differences, views expressed by local regulators, influence from 'previous GAAP'. I am pleased to participate in this process: it is a great opportunity to develop a tremendous network around the firm and to get used to working outside our normal boundaries.

The new process in place is very powerful for us and our clients. They know that the answer they get is the answer from the whole firm.

How do you find living and working in London?

DS

I was surprised to find nice residential areas to live in even in central London. I'm fascinated by the variety of nationalities and cultures that influence

London. For people who have time, London offers a lot of sightseeing opportunities. Although everybody is very busy, people always try to remain polite and treat each other respectfully.

OS

London is somewhat unique since we have in one place access to one of the world's largest business places, an immense cultural life and the countryside. This makes the quality of life very good. And weather and food are not that bad!

SS

It's very different from home. I am still trying to understand it. The medical system, the education system – it takes a lot of getting used to. In China, even though you might not understand the way some things work, because everything is cheap you just give it a try and if it doesn't work out, try something else. Here you cannot afford to do that. But I really enjoy the culture here, we visit the museums and being within Europe, we can travel a lot.

Biography – Shelley So

- LLB, University of London – 1998
- BA (Hons) in Accounting, Hong Kong Polytechnic – 1992
- Member of Hong Kong Society of Accountants – 1995
- Member of Association of Chartered Certified Accountants – 1995
- Joined PwC in Beijing – 2002
- Seconded to the Global ACS Central team – October 2005



Philippe Danjou joins IASB

Philippe Danjou, chief accountant of the Autorité des Marchés Financiers (AMF), has been appointed as a board member at the IASB.

Mr Danjou will continue in his role as director of the accounting division of the AMF, the French securities regulator, until he joins the IASB in November this year. He will replace Geoffrey Whittington, who retired in June after five years at the IASB.

Mr Danjou has significant experience in IFRS; during his time at the AMF, he was responsible for the enforcement of accounting standards by listed companies in France from 1997 to 2006.

Mr Danjou has represented the AMF at CESR (in 2006, he was also appointed chairman of the European Enforcers Coordination Sessions created by CESR-Fin to promote the consistent enforcement by regulators of IFRS) and IOSCO. He has also served in a number of standard-setting organisations at national and international level and has been a member of the IASB's Standards Advisory Council since 2001.

The trustees of the International Accounting Standards Committee Foundation (IASCF) have also reappointed three existing members: Hans-Georg Bruns, Warren McGregor and Tatsumi Yamada.

Illustrative condensed consolidated interim information – for existing preparers



PricewaterhouseCoopers has released a practical guide to applying IAS 34, Interim Financial Reporting. It comprises the following information:

- an illustrative set of condensed interim financial information prepared in accordance with IAS 34 for a fictional manufacturing and retail group (an existing preparer of IFRS consolidated financial statements);
- a disclosure checklist for condensed interim financial information; and
- an overview of IAS 34, including solutions to practical issues.

The publication reflects the IFRS standards and interpretations published up to and including June 2006. To order your hard copy, contact your local PwC office. The PDF version will be available for download on the website from 14 July (www.pwc.com/ifrs).

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