

# IFRS news

Emerging issues and practical guidance\*

Issue 73 – April 2009



## Exposure draft on income tax – an overview

The IASB has issued the long-awaited exposure draft on income taxes. Bill Maloney, senior manager in PwC's Global Accounting Consulting Services central team, explains the key proposals.

The basic principles of accounting for deferred taxes are not affected by the exposure draft. However, the Board has proposed significant changes to the exceptions and disclosure requirements in IAS 12. It has also suggested an entirely new model of accounting when there is uncertainty about the tax obligation. Many of the proposed changes align the IFRS model with US GAAP.

The key proposals are:

- Current and deferred tax assets and liabilities should be measured using an expected value whenever there is uncertainty about the final outcome of the position taken in the tax return. There is no recognition threshold. Additional disclosures about the nature of the uncertainties will be required.
- The tax base of assets is the tax deduction available if the asset was sold at the balance sheet date. Management's expectation about the way assets will be recovered is no longer relevant.
- The initial recognition exception currently applied when assets without a tax base are purchased is removed and replaced with a complicated model that requires the recognition of deferred tax.
- Only investments in foreign subsidiaries and joint ventures qualify for the exception from recognising deferred tax on unremitted earnings. Deferred tax is provided for tax consequences of remitting the earnings of domestic subsidiaries.
- The model used to allocate the charge between the components of comprehensive income and equity might be changed to align with US GAAP. Two alternatives are proposed.
- Deferred tax assets and liabilities are classified as current and non-current items based on the classification of the related non-tax asset or liability. Gross deferred tax assets, together with a valuation allowance, are presented in the notes to the financial statements.

The deadline for comments is 31 July. We encourage preparers and users to carefully consider the proposals and provide comments to the IASB.

More detailed analysis of the proposals is available in this month's supplement to *IFRS news*.

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## Future of lease accounting: a preview

The joint IASB/FASB discussion paper, published last month, may result in a converged leasing standard that brings substantial changes to the accounting for all leases. Marian Lovelace, director in PwC's Global Accounting Consulting Services in the UK, reports.

The discussion paper 'Leases: preliminary views' proposes significant changes to lessee accounting. Accounting by lessors is addressed in the Boards' ongoing revenue recognition project. The leasing discussion paper provides a high-level overview of potential lessor questions and considerations, but it does not include preliminary views on the subject.

The direction of the leasing project is clear for lessees. The Boards have tentatively settled on a right-of-use model. This requires the lessee to recognise an asset representing its right to use the leased asset, and a corresponding liability for its obligation to pay rent. Operating lease accounting under IAS 17, 'Leases', is eliminated. Lessees account for all leases by creating assets and liabilities in a manner similar to that used for finance leases today.

The Boards are aware of possible cost-benefit concerns for small-value and short-duration leases, although they have given no preliminary view on this in the DP. The idea that small-value leases would be exempt from the new standard is troubling to certain Board members, as leases that are individually of low value may be material when aggregated. Some type of bright-line threshold might be necessary to implement such an exception. The IASB has rejected bright lines similar to those in the current IAS 17 model.

The Boards have not reached a single view on how to deal with some common features contained in many lease arrangements (for example, some aspects of contingent rental payments). The discussion paper, as a result, includes several alternatives and asks for feedback from preparers, users and auditors. Even where the Boards tentatively agreed on a single view, more time will be needed to identify and resolve potential inconsistencies within the discussion paper as deliberation on other issues continues.

computer equipment, copiers, office furniture and cars. The practical implications of adopting the proposed model may be most significant for companies leasing a high number of low-value items (such as car fleet).

The proposed model requires the re-measurement of lease obligations at each balance sheet date based on updated estimates, including the probability of exercising renewal options and the amount of contingent rent that the lessee expects to pay over the revised lease term. The re-measurement of the obligation is reflected as an adjustment to either earnings or the right-of-use asset, depending on the nature of the change. This is more onerous than the current model, where lease accounting is set at inception and revisited only if there is a modification or extension of the lease.

The right-of-use model will impact financial statement presentation and financial metrics, including many that are tied directly to debt covenants or compensation arrangements. For example, for a lease currently treated as an operating lease:

- Balance sheets will be 'grossed-up' for the right-of-use asset and the lease obligation.
- The expense recognition pattern will change, resulting in expenses higher than straight-line expense during the early part of the lease term and lower during the latter part of the lease term.
- EBITDA is likely to increase as rent expense is replaced with interest and amortisation expenses, which are generally below-the-line charges.

The economics of leases therefore change as a result of the proposed revised standard. Management may need to re-examine 'lease versus buy' decisions.

### PwC observation

The current accounting for leases takes an 'all or nothing' approach to recognising leases on the balance sheet, which results in significantly different accounting for transactions with similar economic substance. We support the broad direction of the Boards in developing the new lease accounting model.

### Potential implications

The proposed model has the greatest impact on lessees of major capital items, such as real estate, manufacturing equipment, power plants, aircraft and ships. However, it would also affect virtually every company, including those who lease

### At a glance

- The IASB and FASB have issued a discussion paper on lease accounting that will impact most companies.
- The proposal eliminates operating lease accounting. All leases will be treated in a manner similar to how finance leases are accounted for today.
- The Boards expect to release an exposure draft in 2010. A final standard is not likely to be issued until 2011.
- Management should consider the impact of the proposed model on their business activity, financial statement presentation, key financial metrics, internal controls and lease accounting systems.

Accounting for existing leases is unlikely to be grandfathered, given the long-term nature of many leases and the desire for comparability. Management should consider the implications of these potential changes as they negotiate long-term leases, even before the effective date of any standard.

### Timetable

The discussion paper was issued on 19 March 2009. Comments are due by 17 July 2009. The Boards will consider the comments received and continue their deliberations on specific issues, with the expectation of issuing an exposure draft of the new standard in the first half of 2010.

The Boards expect a final standard to be issued in 2011, although they have yet to discuss the effective date or transition provisions.

See also the *IFRS news* supplement on leasing next month, and PwC's IFRS blog on leasing: [www.pwc.blogs.com/ifrs](http://www.pwc.blogs.com/ifrs)

### Key requirements

- Lessees recognise an asset representing its right to use the leased asset, and a corresponding liability for its obligation to pay rent.
- The DP does not give a preliminary view on small value and short-duration leases.
- The Boards have proposed alternative treatments for certain features in lease arrangements (such as contingent rental payments).
- Lessees of major capital items are most affected by the proposals. However, the practical implications of adopting the proposed model may be most significant for companies leasing a high number of low value items (such as computers).
- Lessees re-measure their lease obligation at each balance sheet date based on updated estimates. The re-measurement is reflected as an adjustment to either earnings or the right-of-use asset. This is more onerous than the current model.
- The right-of-use model will impact financial statement presentation and financial metrics.
- Management may need to re-examine 'lease versus buy' decisions.



## Beginner's guide: impairment of non-financial assets



Impairments have been in the news a great deal in the last few months. Behind almost any headline that includes the statement "...largest loss in their history" will be an impairment. So what is an impairment? PwC directors Dave Walters in the UK Accounting Consulting Services and Caroline Woodward in the ACS Central Team explain impairment of non-financial assets.

### What is impairment?

Impairment occurs when an asset is no longer worth the value shown in the financial statements. There can be impairments of financial assets (such as all those toxic investments and loan balances in the news) and non-financial assets (such as buildings, plant and machinery, goodwill and intangible assets). This article focuses on the impairment of non-financial assets (covered by IAS 36, 'Impairment of assets').

An asset should not be carried at an amount that is higher than can be recovered through use (value in use) or sale (fair value less costs to sell). The higher of use or sale is the recoverable amount. Impairment results when the recoverable amount is less than the carrying amount. The principle is 'the higher of the two', so management may have to calculate both. But if one exceeds the carrying amount, the other does not have to be calculated. The two bases of measurement have both similarities and differences as shown in the table opposite.

<b>Value in use (VIU)</b>	Must be a discounted cash flow	Based on management's assumptions	Tests the asset as it is today
<b>Fair value less costs to sell (FVLCTS)</b>	Can be a discounted cash flow but can be based on market prices	Based on market participant assumptions	Tests the highest potential of the asset

### What to test and when?

It is not necessary to test every asset for impairment every year. Goodwill, indefinite-lived intangible assets and intangible assets that are not yet ready for use must be tested every year and when there are indicators of impairment. Other assets are tested only when there is an indicator of impairment. These are indicators that the value might have declined. Some indicators are operating losses, market downturns, damage and an intended change of use for the asset. Recent market conditions

have provided ample practical experience in identifying impairment indicators. These include: companies where the book value of net assets exceeds market capitalisation; plunging commodity prices; and restrictions in available credit and increased perception of risk forcing up borrowing costs.

### How to test?

The accounting principle is that the most accurate impairment picture will be given when assets are tested in the smallest possible groupings and adopts a 'bottom-up' approach. The grouping for impairment is the cash-generating unit (CGU). A CGU is the smallest group of assets that generates cash inflows that are largely independent of those from other assets. A CGU can also be a single asset. Typical CGUs seen in practice are individual retail stores and factories. A CGU will have assets that can be specifically allocated to it (for example, fixed assets within a store) and will include portions of central assets, such as a distribution network if these can be allocated on a reasonable and consistent basis.

Goodwill may be allocated to individual CGUs but can be tested at a higher level by grouping CGUs. The accounting principle is that goodwill is allocated to the parts of a business that will benefit from the acquisition in which it arose and is tested for impairment at the level at which it is monitored for internal management purposes. This level cannot be higher than an operating segment under IFRS 8, 'Operating segments'. The flowchart below shows the process for deciding the level at which to test an asset for impairment.

Where goodwill is not allocated to individual CGUs but there are indicators of impairment, there may be a two-stage testing process. The first stage involves testing individual CGUs for impairment, comparing the recoverable amount with the carrying value of the assets that are allocated to it. Any impairment arising is booked. The second stage is to group CGUs, together with allocated goodwill, and test again.

### Value in use

Companies often perform value-in-use calculations, as this is more straightforward than identifying data to support a market-based fair value measure. The most up-to-date approved cash flow forecasts for each CGU being tested for impairment are required. These forecasts need to be 'reasonable and supportable' and reflect an expected, rather than aspirational, outcome. These forecasts should not exceed a period of five years, as realistic forecasts beyond five years are seldom feasible (imagine the cash flow forecast that Woolworths might have prepared in 2005, for example, and it is clear why a longer period is prohibited by the standard).

A 'terminal value' amount is used for a period after the end of the detailed forecast. The terminal value is an approximation of the cash flows for the rest of the asset's life. This can be indefinite if the asset is a business unit. The terminal value is calculated either by taking the cash flows into perpetuity or by using an exit multiple based on the cash flows in the last year of the detailed forecasts. This represents the price at which the

asset might be sold at that time. The assumptions made in the final year are important, as the terminal value often comprises more than two-thirds of the calculated value of a CGU. To arrive at the VIU, the forecast cash flows are then discounted at a discount rate that reflects the risk inherent in the asset being tested.

There are rules as to what may be included in the forecast cash flows. Costs and benefits arising from future reorganisations are excluded unless the reorganisation has been committed to and already provided for. Costs and benefits arising from future enhancement capital expenditure are also excluded. The asset today is what is being tested.

The discount rate applied to the cash flows reflects the time value of money and the risks that a market participant would consider. There are a number of potential starting points for deriving the discount rate, such as the entity's incremental borrowing rate and the entity's cost of capital. Use of a group-wide discount rate for different businesses in different territories is seldom appropriate, as the rate needs to reflect the risks inherent in each CGU being tested. Some of those businesses will be riskier than others; the discount rates should reflect that. Compare, for example, the risks associated with power generation and those risks associated with a biotech start-up. In addition, discount rates do not remain stable year on year. Risks change, as is obvious in the present environment.

### Fair value less costs to sell

The alternative measure of recoverable amount is FVLCTS. This is the value that a market participant, rather than management, would place on the asset. This may be based on market prices or on discounted cash flow forecasts, depending on the asset being tested. If the latter is used, the assumptions made and valuations produced is benchmarked against external market data. The same observations on cash flows made above are relevant here, except that a FVLCTS calculation could include the costs and benefits of reorganisations or enhancement capital expenditure. These can be included, provided they are realistic and a market participant would make those same assumptions. It would not be appropriate to include a plan for a mass redundancy and related cost savings where local employment laws would make it very difficult to execute the plan.

### Disclosure, disclosure and more disclosure

IAS 36 requires extensive disclosures where impairments occur, for assets that require testing every year and in the case of 'near misses'. If there is an impairment, management must disclose the CGU impacted, the amount of the impairment and the facts and circumstances giving rise to the charge. Additional disclosures are required where riskier assets are tested for impairment (namely goodwill, indefinitely-lived intangible assets), even when there is no impairment. Disclosures include the amounts of goodwill and intangibles by material CGU or group of CGUs, a description of the key assumptions used in impairment testing and details of the discount rates and long-term growth rates assumed. If the key assumptions are not consistent with past experience, disclosure of reasons why is

also required. Further 'sensitivity' disclosure is required if impairment has been narrowly avoided but a reasonably possible change in a key assumption would lead to impairment. This includes quantifying all key assumptions, quantifying how much recoverable amount exceeds carrying value ('the headroom') and analysing, for each key assumption, by how much they would have to change in order to use up the headroom. Headroom is the amount by which the recoverable amount calculated under IAS 36 exceeds the carrying amount

### Challenges in the current environment

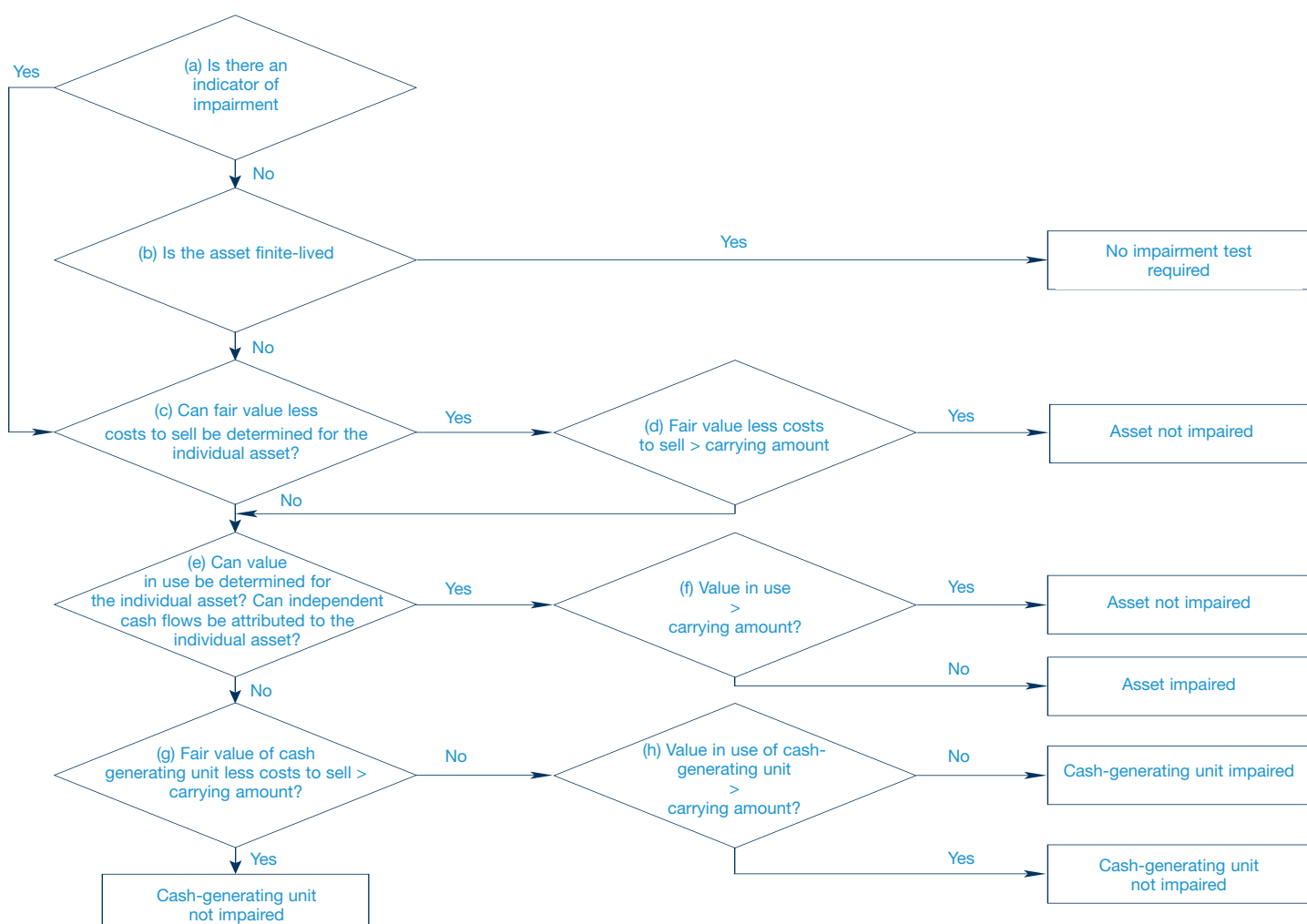
Establishing a 'reasonable and supportable' forecast has been challenging given recent market turbulence. Forecasts have rapidly become out of date in the volatile conditions. Beware

optimistic assumptions, as these are likely to produce an aspirational rather than expected outcome. Optimistic assumptions would include high growth-rate assumption in the terminal year or a return to profit margins experienced in the best of times.

The current fall in risk-free rates (government bond rates) could result in a fall in discount rates. However, although discount rates may have fallen for the least risky assets, there has been a sharp rise in risk pricing, so discount rates are rising for many assets.

Many regulators have targeted the impairment test disclosures for closer scrutiny this year, so more attention may be needed here.

### Decision tree for testing an individual asset





## IFRS for Private Entities

Paul Pacter, guest author and IASB Director of Standards for Private Entities, provides an update on the progress with the standard and explains who will benefit from it.

The IASB has been working since 2003 to develop an IFRS designed to meet the financial reporting needs of private entities. The standard is now finished, with one surprising exception – settling on the name! The exposure draft, published in February 2007, was a proposed 'IFRS for SMEs'. During redeliberations in May 2008, the name changed to 'IFRS for Private Entities'. In January this year, it became 'IFRS for Non-publicly Accountable Entities'. Then, in March, we tentatively changed back to 'IFRS for Private Entities'. The Board will have one more crack at the name in either April or May.

Meanwhile, the Board has made all of the substantive decisions on the content of the final standard, and the draft is currently being revised to reflect those decisions.

### Who will be eligible to use it?

The standard will be applicable for an entity that does not have public accountability, which generally means its securities are not publicly traded and it is not a financial institution. Over 99% of private entities around the world are expected to be eligible to use the standard.

### Is it stand-alone or somehow linked to full IFRSs?

It is a stand-alone standard. The only 'fallback' option is to use IAS 39 and IFRS 7 in place of the financial instruments section of the 'IFRS for PEs'.

### How does it differ from full IFRSs?

Most obviously, the standard differs in size. The final standard will be a little over 200 pages, as compared to 2,855 pages in the 2009 IFRS 'Bound Volume'. It's organised by topic. It also differs significantly in content, with five types of simplifications:

- Some topics in IFRSs are omitted if irrelevant to private entities – for example, earnings per share, operating segments, interim reporting.
- Most of the complex options in full IFRSs are omitted – for example, only the cost method is permitted for PPE, and borrowing costs should always be expensed.
- Simplified principles for recognising and measuring assets, liabilities, income and expense, with limited details (for example, goodwill is amortised, the cost method is used for associates and joint ventures, all R&D is expensed, no corridor approach for pensions, there is much less fair value).
- Reduced disclosures (roughly 400 as compared to 3,000 in full IFRSs).
- Simplified drafting.

The starting point was the 'black letter' principles in full IFRSs. These were simplified based on two criteria: (1) the needs of users of private company financial statements primarily for basic information about short-term cash flows, liquidity and solvency; and (2) cost-benefit trade-offs.

### Why would a private company want to adopt it?

It will be attractive to private companies for many reasons, including:

- Improved access to capital.
- Improved comparability.
- Improved quality of reporting as compared to existing national GAAP (in many countries, local GAAPs for private entities are very limited).
- The focus on the needs of users of SME financial statements.
- Less of a burden for entities in jurisdictions where full IFRSs or full national GAAP are now required.

### When will it be issued?

The timetable calls for Board members to ballot on the final standard in May 2009, with issuance in late June 2009. There is no need for a specific effective date.

### Can private entities simply adopt it once it's issued?

Interestingly, private companies in US the can use the standard without action from the FASB, AICPA or the law because the IASB is now the second designated standard setter (along with FASB) in the AICPA code of ethics. In some countries, on the other hand, currently only full IFRSs and local GAAP can be used. There would need to be a change to local law to permit adoption of the IFRS for PEs.

#### Paul Pacter

- 2003 to date: IASB director of standards for private entities; webmaster of [www.iasplus.com](http://www.iasplus.com)
- 1995-2000: IASC, managing a variety of projects, including financial instruments, segment reporting and discontinued operations
- 1973-84 and 1990-1995: US FASB, deputy director of research
- 1984-1990: Commissioner of Finance of the City of Stamford, Connecticut
- 1984-1989: Vice-chairman of US GASB advisory council
- Late 1980s to mid 1990s: Member of FASB's consolidations task force and GASB's pensions task force
- PhD, CPA

# Cannon Street Press

## ED on derecognition of financial instruments

The Board has published an exposure draft of proposals to improve derecognition requirements for financial instruments. The ED, released last month, proposes that derecognition occurs if an entity no longer controls a financial asset or no longer has an obligation to settle a financial liability. Many of the derecognition outcomes are likely to be similar to those under existing IAS 39, with the exception of transfers involving readily obtainable financial assets. The Board is also proposing to enhance disclosure requirements. The comment deadline is 31 July 2009.

## IFRIC 12 endorsed

The EU endorsed IFRIC 12, 'Service concession arrangements', last month. The effective date for the EU-endorsed version is from annual periods beginning after 29 March 2009. The effective date for entities outside the EU is for annual periods beginning on or after 1 January 2008. Earlier adoption is permitted for all entities.

## PwC global IFRS website relaunched: improved content and navigation

PwC's global IFRS website, [www.pwc.com/ifrs](http://www.pwc.com/ifrs), has been relaunched to provide a one-stop shop for your IFRS needs.

The new-look homepage directs you to the material of most interest to you. If you're planning or in the process of making the change to IFRS, you can learn about the firm's experience in these areas and find out how to contact us for help

If IFRS is 'business as usual' for your company, you can access PwC's latest news and updates on IFRS developments, high-level

guidance via 'topic summaries', as well as publications and information on our IFRS tools.

You can also find information about IFRS application in your country and see local contact details.

Visit [www.pwc.com/ifrs](http://www.pwc.com/ifrs) to see the new service and subscribe to receive updates. You can also keep up to date on the latest news and views in our IFRS blog <http://www.pwc.blogs.com/ifrs/>

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