

# IFRS news

Emerging issues and practical guidance\*

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## Consolidation proposals to change definition of control

Leader of the 'Business combinations' topic team in PwC's Global Accounting Consulting Services, Mary Dolson, looks at the key proposals in the IASB's staff draft of a new consolidation standard.

The requirements in the proposed standard change the definition of control under consolidation accounting so that the same criteria are applied to all entities to determine control. The definition will be supported by extensive application guidance that addresses the different ways in which a reporting entity (investor) might control another entity (investee).

The changed definition and application guidance is not expected to result in widespread change in the consolidation decisions made by IFRS reporting entities, although all entities will need to consider the new guidance. The core principle that consolidation presents a parent and its subsidiaries as if they are a single entity remains unchanged, as do the mechanics of consolidation.

The staff draft excludes disclosures and any guidance specifically for investment companies and omits the previous guidance on preparation of separate financial statements. Disclosures will be included in a comprehensive disclosure standard to be published this year, which will cover disclosure principles for subsidiaries, joint ventures and associates.

The IASB plans to issue an exposure draft in 2010 of guidance for investment companies. An investment company would be required to report investees that it controls at fair value rather than consolidate those investees. The status of the guidance on separate financial statements is unclear, but the relevant portion of current IAS 27, 'Consolidated and separate financial statements', may be retained.

The new standard, when issued, will replace IAS 27 and SIC-12, 'Consolidation – special purpose entities'. The staff draft includes the decisions made by the IASB following comment letters and the redeliberations of ED 10, 'Consolidated financial statements', which was published in December 2008. It is not a required due process document, but it has been published to facilitate upcoming roundtable discussions.

Consolidation is a joint project between the IASB and the FASB under the Memorandum of Understanding. The two Boards will jointly host roundtable discussions on the IASB staff draft in the US in October 2010. The views gathered during this process will be used

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by the FASB in its consolidation project. The IASB plans to issue its final standard in the fourth quarter of 2010.

### Revised definition of control

The revised definition will focus on the need to have both power and variable returns before control is present. Power is the current ability to direct the activities that significantly influence returns. Returns must vary and can be positive, negative or both.

The determination of power is based on current facts and circumstances and is continuously assessed. The fact that control is intended to be temporary does not obviate the requirement to consolidate any investee under the control of the investor. Voting rights or contractual rights may be evidence of power, or a combination of the two may give an investor power. Power does not have to be exercised. An investor with more than half the voting rights would meet the power criteria in the absence of restrictions or other circumstances.

The application guidance includes examples of when an investor may have control with less than half of the voting rights. When assessing if it controls the investee, an investor should consider potential voting rights, economic dependency and the size of its shareholding in comparison to other holdings, together with voting patterns at shareholder meetings. This last consideration will bring the notion of 'de facto control' firmly within the consolidation standard.

The staff draft also includes guidance on participating and protective rights and agent/principal relationships. Participating rights give an investor the ability to direct the activities of an

investee that significantly affect the returns. Protective rights (often known as veto rights) may restrict an investor's ability to control if the rights apply to decisions in the ordinary course of business.

An investor (the agent) may be engaged to act on behalf of a single party or a group of parties (the principals). Certain power is delegated to the agent – for example, to manage investments. The investor may or may not have control over the pooled investment funds. The staff draft includes a number of factors to consider when determining whether or not the investor has control or is acting as an agent.

### Am I affected?

The proposed standard has the potential to affect all reporting entities (investors) (other than investment entities) that control one or more investees under the revised definition of control. The determination of control and consolidation decisions may not change for many entities. However, the new guidance will need to be understood and considered in the context of each investor's business.

### What do I need to do?

The IASB has not requested formal comments on the staff draft but would welcome input. US GAAP preparers may wish to participate in the FASB roundtable discussions.

IFRS preparers should consider whether the planned standard will affect their control decisions and consolidated financial statements.

## Cannon Street Press

### IFRS 1 amendment regarding severe hyperinflation

The IASB has issued an exposure draft proposing an amendment to IFRS 1, 'First-time adoption of International Financial Reporting Standards'. The amendment would create an additional exemption when an entity resumes presenting financial statements in accordance with IFRSs after being subject to severe hyperinflation. The exemption would allow an entity to elect to measure assets and liabilities at fair value and use that fair value as the deemed cost of those assets and liabilities in the opening IFRS statement of financial position.

The proposed amendments are believed to have a limited impact, because the exemption is only available to entities whose functional currency was subject to severe hyperinflation. The Zimbabwean economy, for example, has been identified as

an economy that was subject to severe hyperinflation until quarter one of 2009; the proposed amendment is unlikely to apply in other territories.

The proposed effective date is expected to be 1 July 2011, although this was not stated in the exposure draft. Earlier application is expected to be permitted.

The IASB is requesting comments on the proposed amendment to IFRS 1 by 30 November 2010. Management of entities in Zimbabwe and other territories that believe they are or may be subject to severe hyperinflation should consider commenting on the proposed amendment.

# Deferred tax accounting for certain assets measured at fair value

The IASB has issued an exposure draft proposing an exception to the existing principle for the measurement of deferred tax assets or liabilities arising on certain non-financial assets measured at fair value. The proposals would reduce the deferred tax assets and liabilities recognised by entities that hold these non-financial assets in territories where the capital gains tax rate is different from the income tax rate. Tony de Bell, Moi Lre Kok and Michele Embling in PwC's Global Accounting Consulting Services look at the detail.

The current principle in IAS 12 requires the measurement of deferred tax assets or liabilities to reflect the tax consequences that would follow from the way that management expects to recover or settle the carrying amount of the entity's assets or liabilities. For example, management may expect to recover an asset by using it, by selling it or by a combination of use and sale. Management's expectations can affect the measurement of deferred taxes when different tax rates or tax bases apply to the profits generated from using the asset for part of its life, then selling it.

Entities holding investment properties that are measured at fair value may find it difficult or subjective to estimate how much of the carrying amount will be recovered through rental income (that is, through use) and how much will be recovered through sale, particularly when there is no specific plan for disposal.

The IASB has proposed an exception to the principle in IAS 12. The proposal introduces a rebuttable presumption that certain assets measured at fair value are recovered entirely by sale. The rebuttable presumption applies to the deferred tax liabilities or assets that arise from investment properties, property, plant and equipment or intangible assets that:

- are measured using the fair value model or revaluation model; or
- are initially measured at fair value in a business combination, if the acquirer subsequently uses the fair value model or revaluation model to measure those assets.

The presumption of recovery entirely by sale is rebutted when there is clear evidence that the entity will consume the asset's economic benefits during its economic life.

SIC-21, 'Income taxes – Recovery of revalued non-depreciable assets', will be withdrawn by the amendment.

## Transition

The amendment would be applied retrospectively, with early adoption permitted. The IASB is also seeking comments on whether specific transition guidance is needed for previous business combinations. No effective date is set, but the IASB intends to finalise the amendment for early adoption by entities with December 2010 year ends.

## Am I affected?

All entities holding investment properties, property, plant and equipment or intangible assets measured at fair value in territories where the capital gains tax rate is different from the income tax rate (for example, Singapore, New Zealand, Hong Kong and South Africa) will be significantly affected. The proposals would reduce the deferred tax assets and liabilities recognised by these entities.

## What do I need to do?

The comment period ends on 9 November 2010; a final amendment is expected in December 2010 or early 2011. Management should begin to assess the implications of the proposal on their existing deferred tax liabilities or assets arising on investment properties, property, plant and equipment and intangible assets measured at fair value. Management should also consider commenting on the exposure draft to ensure their views on the proposed changes are considered.

## PwC industry guidance on revenue proposals

The IASB and the FASB released an exposure draft in June 2010, proposing a new revenue recognition standard that could significantly change the way entities recognise revenue. PwC has published a '[Practical guide to IFRS](#)' exploring the proposed standard and the implications. We have also produced supplements to the 'practical guide' looking at the more significant implications for particular industries. These are:

- Engineering and construction
- Entertainment and media
- Industrial products
- Pharmaceuticals and life sciences
- Retail and consumer
- Technology

More industry-specific supplements will be available over the next few weeks, including real estate, hospitality, aerospace and defence, asset management, telecoms, and transportation and logistics. Visit [pwc.com/ifrs](http://pwc.com/ifrs) to see the latest editions, or [click here](#).



## Is management ready for changes to lease accounting?

The IASB and FASB published the proposed new leasing standard in August this year, after more than 10 years of debate. The proposed model would significantly change lease accounting for lessees and lessors (see also *IFRS news*, September 2010, p1). Marian Lovelace from PwC's Accounting Consulting Services in the UK looks at management's readiness, as revealed in a recent PwC survey.

Sir David Tweedie warned in 2004 that 'there could be blood all over the streets', anticipating objections from preparers who might feel the leasing proposals would have a negative impact on their financial statements. PwC and the Rotterdam School of Management undertook a survey to understand the perceptions and reactions of European preparers with respect to the proposed overhaul of lease accounting. So, were Sir David Tweedie's predictions correct?

### Lack of awareness

The majority were aware of upcoming changes in the lease standard, although just under half said that they were not well informed of the issues at this stage. Nearly half were unable to assess to what extent changes would be needed to business models, business and financial processes, IT systems, reporting and closing processes, internal controls, internal performance measurement systems, and budgeting and tax planning strategies. However, they understood that change would be needed, even though they could not assess the extent of change required.

The effective date of a new standard is some way off, but preparers should start to analyse and quantify the operational and practical implications now, given the pervasive impact. Only a quarter of those responding said they currently had the resources available to implement a new lease standard. This problem is exacerbated by the volume of change from the IASB.

### Data-hungry

Additional data will be required to implement the new proposals. The vast majority of respondents said that they might ask their providers of leasing services (lessors) for the data on initial application of the standard and on an ongoing basis; only a small percentage of these respondents have initiated discussions with their lessors. Lessors and lessees will need to overcome the commercial challenge of agreeing who will bear the costs, but coming up with solutions for lessee's needs in this respect may provide some lessors with a competitive advantage.

The proposed right-of-use model for lessee accounting will result in higher total expenses in the earlier periods of a lease and lower expenses in the later periods compared to the pattern for operating leases today. Entities will need to consider the

impact on the ratios and performance measure, including the effect on:

- net earnings where renegotiating compliance and performance targets in financing arrangements;
- agreements with suppliers and vendors; and
- employee compensation agreements.

The majority responding were able to assess the significance of the impact on their operating income, EBITDA, operating cash flows and interest coverage. The implications for balance sheet ratios such as debt to equity (leverage), asset turnover ratios and return on capital employed were also well understood.

### Communicating the impact

Users traditionally adjust financial statements to add operating lease payments as financial liabilities. Previous research by PwC showed that there will be a significant difference between adjustments made to financial statements by users today and the actual impact of the new lease standard. Nearly half of respondents to the most recent survey believed that the proposed changes to the lease standard would not result in a decline in their credit rating, increase in cost of capital or breach in existing covenants.

The challenge for preparers is to avoid 'surprise' changes that can trigger negative market reactions. This expectation gap, unless managed properly, might result in changing perceptions of entities' financial strength after the transition to the new lease standard. Only 10% of respondents said that they had discussed their changes with shareholders and investors. The majority do not expect shareholders and/or investors to request information about these impacts until the final standard is

### Methodology

- The survey was conducted based on the IASB's proposed changes to lease accounting in the Discussion Paper, 'Leases: Preliminary views', released in March 2009.
- The survey was conducted with preparers acting solely as lessee (106 entities) or acting as lessee and lessor (19 entities).
- The fieldwork for the survey was completed prior to the release of the ED in August 2010 and therefore did not obtain lessors' views on lessor accounting proposed in the ED.
- Approximately 125 companies from 21 European territories and various industries responded.

issued, or even as late as the date of adoption. Early communication with stakeholders is key to managing any expectations gap that could arise.

### Banking capital requirements

One further impact of the change to the balance sheet as a result of the proposed lease standard may be on regulatory capital. Over 70% of the banking survey participants were uncertain whether the new lease standard would affect their required regulatory capital. Management should assess whether changes are needed to capital requirements as a result of the new leasing standard.

### Cost/benefit

The investor community in their feedback on the discussion paper said that the new leasing standard would provide greater transparency, comparability and relevance of financial information. The majority of preparers in that survey agreed, but only 3% believed the improvement would be significant. The increased complexity and judgement required in estimating

renewal options and contingent rents were cited as the factors limiting the usefulness of the information. Others felt that the increased subjectivity of the new requirements would actually reduce comparability between lessees.

The majority of preparers said that they expect the implementation costs and the cost of ongoing accounting complexity for renewal options and contingent rentals to be quite or very significant. Almost three quarters of respondents said that the costs will exceed the benefits to users of their financial information.

So has Sir David Tweedie's prediction come true? Is there 'blood on the streets'? It is probably too early to conclude. The PwC survey has shown that many preparers have yet to understand the details of the proposed standard or the potential impact on their business and operations.

The effective date may seem some way off, but preparers should understand the operational and practical implications now – to ensure that they are able to assess the impact to their organisation and that they make the most of the opportunity to contribute high-quality input and views to the IASB.

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