IFRS News

Emerging issues and practical guidance*

Issue 66 – September 2008

IFRIC agenda – what to expect in coming months

***IFRS News* catches up on the IFRIC agenda, looking back at activity in 2007-8 and what to expect over the next few months. By Menachem Steinberger, Michael Stewart and Jessica Taurae.**

The IFRIC has been busy in the last 12 months. From June 2007 to July 2008, it considered 22 issues and rejected 19 of them.

The reasons for the rejections were:
- Current guidance is sufficiently clear (6 submissions);
- Referred to the Board for possible inclusion in the Annual Improvements project (5);
- Issues were already on the Board's agenda (4);
- Application guidance is needed, not an IFRIC interpretation (2);
- IFRIC did not expect diversity in practice (1); and
- The issue is not sufficiently widespread (1).

The submissions concerned the standards below. IAS 19 and IAS 39 are acknowledged to be complex and contain detailed guidance. It will come as no surprise, therefore, that there are more submissions on these standards than the others.
- IAS 19 (8 submissions);
- IAS 39 (5);
- IAS 37 (2);
- IFRS 5 (2); and
- one each on IAS 7, IAS 12, IAS 16, IAS 18 and IFRS 3R.

IFRIC member and head of the IFRS technical function in PwC Germany, Guido Fladt, believes IFRIC's ability to address the most pressing issues would be enhanced with input from business.

"I would like to see more involvement from preparers. We don't know where the submissions come from; however, I know those that come from PwC and sometimes those from other firms. From this I know that there are very few submissions from preparers and users. I would urge preparers and users to get involved, engage with IFRIC, talk to your local IFRIC member and send in your submissions."

Current significant activities are outlined below and categorised as 'final interpretations published/due', 'rejections in progress' and 'agenda decision pending'

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Final interpretations published/due

D24, Customer contributions

The IFRIC has updated the draft interpretation (see *IFRS News*, April 2008). The update:

- includes indicators as to when an asset should be recognised by the entity that receives the contribution,
- identifies whether connection services are a separate element from the ongoing service of providing access to the network, and
- includes examples.

D23, Distributions of non-cash assets to owners

This issue addresses the accounting for circumstances in which a company pays a dividend to its shareholders using assets other than cash – for example, shares or a tangible fixed asset. The most commonly seen non-cash distribution is when a group splits itself and issues its shareholders with shares in both parts of the group.

Draft interpretation D23 was published in January, and the IFRIC's re-deliberation of the proposals is almost complete. An IFRIC interpretation is likely to be issued in the next few months (subject to final IFRIC agreement and IASB approval).

The interpretation is expected to require a significant change in accounting by many companies. It will require a liability to be recognised at the fair value of the non-cash assets to be distributed. When the distribution occurs (and the liability settled), the difference between the book value of the asset distributed and the amount recorded for the liability is recognised as a gain in the income statement. Many companies have traditionally recorded the liability at the book value of the assets to be distributed, thus no gain was recognised when the distribution occurred. Non-cash distributions of this type do not occur frequently for an individual company but are usually material when they do. A traditional spin-off or de-merger will be captured by this new guidance.

Rejections in progress

IAS 18, 'Revenue': accounting for trail commissions

The IFRIC was asked to provide guidance on how an entity should account for ongoing commission arrangements ('trail commissions') where the contractual obligation for the payment/receipt of the commission is not linked to the performance of any future service – for example, when a financial advisor receives an initial commission for the placement of business from the investment manager and a further ongoing trail commission provided that the client remains invested in the fund for a specified period of time.

The IFRIC noted that similar arrangements are present in many industries and therefore the issue is widespread, and that practice in this area is diverse. Given the complexity of the issues and the pervasive effect of any conclusions reached, the IFRIC said it would not be able to reach a consensus on a timely basis. It also noted that the IASB is considering these issues in its projects on revenue recognition and liabilities. For all those reasons, it has tentatively decided not to add this item to its agenda. This is expected to be confirmed as a final decision at its meeting this month.

IAS 32, 'Financial instruments: presentation': Transaction costs to be deducted from equity

The IFRIC received a request for guidance on the extent of transaction costs that can be deducted from equity. The issue relates to the meaning of the terms 'incremental' and 'directly attributable'.

IAS 32 was clear, IFRIC noted, that only incremental costs directly attributable to issuing new equity instruments or acquiring previously outstanding equity instruments are related to an equity transaction. Costs related to other activities undertaken at the same time, such as an IPO, are not costs incurred in issuing or acquiring its own equity instruments.

The IFRIC therefore decided not to add this item onto its agenda but to recommend to the IASB that common definitions should be developed for the terms 'incremental' and 'directly attributable' and included in the Glossary, possibly as part of the annual Improvements project, as they are used in other standards with similar but not necessarily identical meanings. This is expected to be confirmed as a final decision at its meeting this month.

Agenda decision pending

Customer-related intangible assets

IFRS 3 (revised 2008), 'Business combinations', requires customer-related intangible assets to be recognised as separate assets when acquired in a business combination. The prime example is the relationship that the acquiree has with its customers: this is a valuable asset and is required to be recognised at fair value if certain recognition criteria are met.

The application of recognition criteria in IFRS 3R differs according to whether the customer relationship is contractual or non-contractual. Distinguishing between contractual and non-contractual relationships has proved challenging and led to diversity in practice. The IFRIC will consider a request at its meeting this month to add this to its agenda.

IAS 39, 'Financial instruments: recognition and measurement':

(a) Valuation of restricted securities

The IFRIC received a request for guidance on whether a discount should be applied to the quoted market price of an equity instrument when establishing fair value when there is a contractual, governmental or other legally enforceable restriction that is specific to the current holder that prevents the sale of the equity instrument for a specified period.

The IFRIC will discuss whether to add this topic to its agenda at its meeting this month. It is not expected to take this topic onto its agenda, as there is already guidance in IAS 39.AG72, which states that the fair value of a portfolio of financial instruments is the product of the number of units of that instrument and its

quoted price. In addition, the IASB's project on fair value measurements will address this issue. Lastly, examples 8 and 9 of FAS 157, 'Fair value measurements', discuss restrictions on sales of security and distinguishes between restrictions that are specific to the security and would therefore transfer to other market participants, versus those that are specific to the current holder. If the restriction is specific to the holder and would not transfer to other market participants, FAS 157 is clear that the market price is not adjusted. In our experience, IFRS is in practice applied the same as FAS 157 in this regard.

(b) Derecognition of financial assets

This item has been on IFRIC's agenda for at least three years. The issues being considered are:

- How the derecognition tests should be applied to groups of financial assets, and
- When the pass-through tests of IAS 39 should be applied to a transfer of financial assets.

This project was officially added to IFRIC's agenda in January 2007 after a number of comment letters on its tentative rejection. IFRIC may consider taking it off its agenda, as the Board has recently agreed to do a derecognition project. However, the Board may take some time to deliver on it due to a lack of resources. In the meantime, it remains on the IFRIC agenda.

The issues continue to cause significant concern in practice though, and it would be helpful for the IFRIC to provide some clarity and reduce the diversity in practice.

Regulatory assets and liabilities

The IFRIC has received a request to consider whether regulated entities could or should recognise a liability (or an asset) as a result of price regulation by regulatory bodies or governments. The IASB is collecting and analysing information in order to make a recommendation on whether or not the item should be added to the IFRIC's agenda. The IFRIC will be discussing the item at the meeting this month; it is also a proposed agenda item for the November meeting.

This is a significant issue for utility companies. Many European utility companies took the view that such assets and liabilities could not be recognised under IFRS when they transitioned in 2005. However, the recognition of regulatory assets and liabilities is more prevalent in Canada and the US, both of which are on the road to adoption of IFRS. The rate-regulated companies in North America will be following this issue closely.

Compliance costs for REACH

The European Regulation concerning the Registration, Evaluation, Authorisation and Restriction of Chemicals (REACH) came into effect on 1 June 2007. It requires companies dealing with certain types of chemical to implement controls and procedures surrounding their use. The IFRIC has been asked to issue guidance on how to account for the costs incurred in complying with REACH – for example, whether some or all of the costs should be capitalised. The IFRIC agreed at its July meeting to add the issue to its agenda. It is currently analysing the issue further.

Financial reporting haiku competition

IFRS News invites you to sharpen your pencils and your wits, and join in our friendly haiku competition. IASB member Tatsumi Yamada will choose the winner. Faithfulness to the genre and consideration of the subject matter will be under scrutiny.

A haiku is a short, 'naturalistic' form of Japanese poetry. It usually implies a sense of immediacy and connection with nature (the naturalistic aspect may need to be foregone for the purposes of our competition, but points may be awarded for covering all haiku characteristics). Haiku in English are usually written on three lines. They consist of five, seven and five syllables. We have provided a few examples below to inspire you to contribute. You may also wish to consult the following website, although there are many on the subject: http://www.haiku.jp/haiku/nyumon_English.htm

Entries should be submitted by 29 September to: corporatereporting@uk.pwc.com. The top three haiku, as decided by Mr Yamada, will be published in *IFRS News*, and the authors will receive a signed copy of PwC's *IFRS Manual of Accounting*.

So many credits
on the left. Debits eat
profit. No cash left

Goodwill is the name
and then impairment.
Winter of the business

Investigate with
Care. Despite diligence
Overpay, impair.

Impairments – coming to a set of financial statements near you

The last 12 months have not been plain sailing for the world economy. The ripples from the credit crunch are being felt in territories and markets across the world as growth slows. This slowdown will increase the likelihood that impairment charges need to be taken and appropriate disclosures made. IAS 36, 'Impairment of assets', is one of the more complicated accounting standards. This makes getting the accounting and disclosures right more of a challenge. Dave Walters takes a look.

'Reasonable and supportable'

The assumptions used in arriving at the recoverable amount need to be 'reasonable and supportable' regardless of whether impairment calculations are based on fair value less costs to sell or value in use. The acceptable range for such assumptions will change over time, and forecasts for revenue growth and profit margins are likely to have fallen in the last 12 months. Discount rates may have risen too as risk premiums rise. Have the assumptions been reviewed and changed to bring them up to date? Are the assumptions made by management in line with the assumptions made by industry commentators or analysts? Variances from market will need to be justified and highlighted in financial statement disclosures.

What type of impairment calculation is it?

The calculations of recoverable amount based on fair value less costs to sell or value in use differ. A common error is to describe the calculation as being on a value in use basis but then include in the forecast cash flows the costs and benefits of future reorganisations and enhancement capital expenditure. Both of these are prohibited from inclusion in a value in use calculation. They could be included in a fair value less costs to sell calculation if the reorganisations and enhancement capital expenditure are consistent with the assumptions that other market participants would make.

Does the answer look sensible in the current market?

Whatever method has been used to calculate the recoverable amount, the number produced by the model needs to be considered in the light of available market evidence. The old computer-related adage of 'garbage in, garbage out' also applies here. The simplest test to perform is to compare the values implied by the valuation models with current share prices or prices achieved in recent market transactions. Clearly, where a direct market price is not available, alternative data may need to be reviewed, such as market prices for comparable entities. Where evidence is available from market data relative to total valuations or key assumptions, it should not be ignored. Where other entities in the same sector are taking impairment charges, the absence of an impairment charge should be carefully investigated and justified – not least because the market will be asking the same question.

How do I test goodwill?

The level at which goodwill is tested depends on how it has been allocated to cash-generating units (CGUs). If goodwill has not been allocated to individual CGUs, as is often the case, but is monitored at a higher level, a two-stage impairment test is required. Firstly, impairment testing is performed at individual CGU level, comparing individual CGU recoverable amounts with the assets that have been directly allocated to the CGU (for example, a retail store for a retailer). Any impairment identified at this level is allocated to the fixed assets being tested. Secondly, the recoverable amount of the group of CGUs to which goodwill relates is compared with all of the assets of those CGUs plus the goodwill. At this second stage, any impairment is charged against goodwill until that is exhausted.

Watch out for the disclosures

The IAS 36 disclosures are extensive. What follows is not a comprehensive list; it is a reminder of the main areas where disclosures have been historically weak. Required information where there is an impairment arising includes impairments charged, identification of which CGUs have been affected by impairments and discount rates applied. Even where there is no impairment, certain assumptions have to be disclosed (notably long-term growth rates and discount rates), and the identification of key assumptions and the approach to determining them is required.

Where a reasonably possible change in a key assumption would give rise to an impairment, additional extensive sensitivity disclosures are required. These include the quantification of all the key assumptions, by how much they would have to change to remove all of the headroom, together with the headroom currently shown by the calculations. We expect to see considerably more sensitivity disclosures in 2008, as headroom reduces due to deteriorating market conditions; also the range of reasonably possible changes in many key assumptions increases as market volatility increases. Regulators around the world are focusing on impairment disclosures, as are other users of financial statements, so care is needed here.

What to do now?

Simply put, start the process early. Goodwill has to be tested annually, but the standard allows for goodwill to be tested before the year end to assist companies with the complicated and time-consuming process. Remember, though, that goodwill and other assets need to be tested when there is a trigger event. Notwithstanding the risk of a trigger post the goodwill testing, getting a head-start on the process will identify problem areas early and avoid a late rush and unwelcome surprises during the latter stages of the year-end process.

Making sense of a complex world – accounting for handsets and subscriber acquisition costs

There is no prescriptive guidance within IFRS on accounting for sales of mobile telephone handsets or for subscriber acquisition costs, and practice is divergent. PwC's Telecoms Industry Accounting Group has developed a framework to help in the analysis of how to account for these increasingly complex transactions. Peter Hogarth and Rich Sharko, partners in PwC's Accounting Consulting Services Group and members of the firm's Telecoms Industry Accounting Group, tell us more.

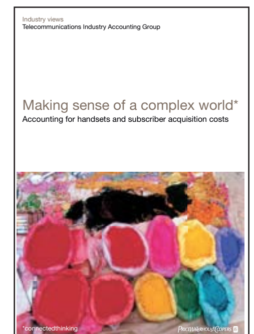
There is significant variation in the ways in which mobile operators account for handset sales and subscriber acquisition costs. IFRIC has acknowledged this variation, and has twice considered and twice declined to take the topic onto its agenda, most recently in March 2006.

The operational and commercial models adopted by operators vary widely across markets and also change over time. It is therefore difficult to be prescriptive about how to account for this type of business. PwC has developed a broad framework to assist in understanding the issues involved and to explain the rationale for some of the more common accounting treatments we have seen in practice. It does not address every situation that may occur in practice, nor is it intended to dictate or preclude any particular accounting treatment. Each situation should be considered in light of the relevant facts, with the objective that the accounting treatment adopted most faithfully reflects the commercial substance of the arrangement and, of course, is permissible under IFRS.

The discussion paper *Making sense of a complex world – accounting for handsets and subscriber acquisition costs* explores some of the more complex questions, such as:

- Does providing a handset together with service constitute one or more deliverables that may need to be accounted for separately?
- Should costs arising from the connection of a new customer be expensed as incurred or treated as an asset and expensed over a period?
- What difference does it make if the operator connects customers via a third-party dealer?

There is no generic answer to these questions; the paper proposes the following six guiding principles to assist in determining the most appropriate accounting treatments:



1. Accounting for handset sales should reflect the economic substance of the transaction.
2. The cost of acquiring a customer contract should be treated as an intangible asset if it meets the recognition criteria under IAS 38.
3. The accounting treatment for handsets and acquisition costs should be consistent whether or not a dealer is involved.
4. Accounting for handset inventory should be consistent with the accounting for the disposition of the handset.
5. The accounting useful life of an SAC asset reflects the nature of the asset.
6. The nature of payments to dealers, not their timing, drives the accounting treatment.

This paper is intended to be the first of a series. Future papers scheduled for publication in the next year will address other topical subjects, such as accounting for customer incentives, telecom licences and impairment. View the pdf under 'Publications' at www.pwc.com/telecom

IFRS survey – your feedback needed!

PricewaterhouseCoopers is continually seeking to enhance its IFRS publications and online offering. We welcome any feedback you have to help us develop our IFRS materials. If you would like to provide input to our development process, you can complete a quick survey by following the weblink below.

The survey should take no longer than five minutes to complete. All of the data will be analysed at a total level, and no comments will be attributed to an individual.

We would be grateful for your responses by 15 September 2008. Many thanks for your contribution to help us improve our products.

https://surveycenter.pwc.com/se.ashx?s=1A73120472CDACFA

Financial instruments – know your options

Derivatives have been a hot topic for some time and the subject of much debate by standard setters. The high-profile financial losses at Barings and more recently at Société Générale show how wrong things can go (and how rapidly). One particularly complex form of derivative, written options, can expose a company to effectively unlimited losses. However, the use of options is important in many risk management strategies. Stanislav Varkalov gets back to basics.

Derivatives are becoming more visible because more companies are using them and new variants of instruments appear continuously. Their appearance in companies' income statements and balance sheets has been driven by the relatively recent introduction of some complex accounting standards such as:

- IAS 32 (debt/equity presentation, offsetting of financial instruments),
- IAS 39 (recognition and measurement),
- IFRS 7 (financial instruments disclosures), and
- IFRS 2 (share-based payments).

Options are one of the most complex areas in the world of derivatives. Options terminology also seems incomprehensible to non-specialists; this article attempts to explain some of the basic concepts.

What is an option?

Options are financial instruments that convey the right, but not the obligation, to enter into a future transaction on some underlying instrument (for example, to buy a share). Options involve two parties; the 'writer' of the option and the 'holder' of the option. The holder of the option has the 'optionality' and does not have to enter into the transaction. The writer of option, however, must perform (buy or sell) if the holder demands that they do so (ie, exercises their right).

Buying an equity **call** option provides the holder with the right to buy (or 'call') a specified number of shares at a specified strike price from the writer. The strike price is the price at which a specific option contract can be exercised – also known as the 'exercise price'.

Buying a **put** option provides the holder with the similar right to sell (or 'put') the shares to the writer of the option in the future at a specified price at a specified date or dates. The person buying the option (the holder) is only at risk for what they spend on the premium. The party that issues ('writes') the option is the party that takes on substantial risk.

When the option holder decides to exercise the option, the party who sold ('wrote'), the option must fulfil the terms of the contract – ie, deliver the underlying item (for a written call) or buy the underlying item (for a written put) at the price specified in the option.

The written option therefore exposes the writer of the option to risk because they have to perform under the option; their counterparty does not have to. The price of the underlying may go up or down in value after the option was written, so the holder will only exercise the option if it is beneficial for them. The holder's benefit is the writer's loss.

The writer of the option will want to be compensated for the risk of that loss; this compensation is called a 'premium'. An option premium is usually paid upfront by the holder to the writer of the option.

Option payout (winners and losers)

Using the example of a simple option over an equity share, here is a walk through of the economic exposure or protection offered by written and purchased options.

Purchased call equity option

The option price is the premium paid for the option. If the market price of the underlying share is higher than the strike price, the holder of the option will 'exercise' it – ie, will buy the underlying share at the strike price. If the holder then sells that share at the market price, they will realise a gain on that transaction. A purchased call represents an expectation by the holder that prices of the underlying item will rise above the strike price.

Purchased put

For a purchased put option, if the actual price of the underlying share at option's maturity date is lower than the strike price of the option, the holder of the option will sell the shares to the writer of the option at the strike price. They will realise a gain on that transaction, as they will be selling the share at the value higher than the market value of the share. A purchased put represents an expectation by the holder that prices of the underlying item will fall below the strike price.

The option holder suffers some initial cash outflow in both cases. They had to pay a premium to the option writer for taking on the risk that the option will be exercised. If the actual price on expiry of the option is lower than the strike for a purchased call or higher than the strike for a purchased put, the holder will not exercise the option (lets it 'lapse'). The only loss the buyer of the option would suffer would be the premium paid.

Written options expose the writer to considerably more risk.

Written call

The holder has the right to buy the share at the strike price and if the price of the shares increases, then the writer of the option

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is exposed to the difference between the strike price and the market price. There is no theoretical limit on the potential loss that might be suffered by the writer. The practical limit is how high share prices might rise during the period that the option can be exercised. However, if the actual price at maturity is lower than the strike price of the call option the writer profits from the premium, the option holder does not exercise the option and loses the amount invested in the premium.

Written put

The holder of a put has acquired the right to sell the shares at the strike price to the writer. If the price of the share declines, the writer of the option is exposed to potentially significant losses. These losses are only limited to the difference between the strike price (what the writer has agreed to pay) and zero (assuming that prices could fall that far).

Time value, intrinsic value

The intrinsic value of the option is the difference between the strike price in the option and the actual price of the underlying item. There are a number of slightly different ways to define the intrinsic value of the option – all beyond the scope of this article. The intrinsic value of the option is important as it comes into hedge accounting (also beyond the scope of this article). Hedge accounting will be the subject of a future article in this 'beginners' guide' series.

Time value is that part of the fair value of the option, which at inception usually equals the premium paid for an 'out-of-the-money' option. That is, time value is the part of the value of an option that is affected by the likelihood that the strike price will go above current market price ('spot price') during the term of the option. This is driven primarily by the time to maturity, difference between strike and spot, volatility of the price of the underlying item (ie, how variable is the spot price?) and other factors. The time value of an option decreases at a faster rate the closer it is to maturity. Thus an option premium is likely to be higher in volatile markets with a long time to maturity.

America, Europe, Bermuda or the barrier reef

Different types of options can be exercised at different times. The different types of exercise periods generally used include:

- European – an option that may only be exercised on expiration (ie, at the maturity date).
- American – an option that may be exercised on any trading day on or before maturity date.
- Bermudan – an option that may be exercised only on a number of specified dates on or before expiration.
- Barrier – any option with the general characteristic that the underlying instrument's price (or any other price or index) must reach some trigger level before the exercise can occur.

Why do accountants care about options?

Options are widely used in the hedging of financial and commodity risk and for employee compensation; thus crucial in two of the most complex areas of accounting. For example, companies hedge:

- interest rate risk using interest rate caps, floors and collars;
- foreign exchange risk using foreign currency options; and
- commodity risks using purchased commodity options.

Options are either 'over the counter' or tailored to individual company requirements in terms of notional amounts, strike prices, maturity, etc. Some options, notably FX options, are also exchange-traded – these are standardised as to notional amounts, maturity and strike prices. Options traded on liquid derivatives exchanges generally involve lower premiums (as tailored derivatives involve additional costs for holders and writers) and represent a lower credit risk for the holder (as the counterparty is not a bank but an exchange).

These are not the only areas where options are used. Some seemingly non-optional instruments (for example, an interest rate swap) can contain option features (for example, a cancellation provision) that are not obvious from the name of the instrument or from a quick look at its terms.

Options have also recently been 'en vogue' at the IASB. A July 2008 amendment to IAS 39 'Eligible hedged items', disallowed designating the full fair value (ie, intrinsic and time values together) options in a way that results in no ineffectiveness. After the effective date of the amendment, only the intrinsic value of an option may be treated as a fully effective hedge of a one-sided risk.

The world of options and option hedging strategies can be extremely complex. This article intends to explain the basic economics of options and some of the main terms used to describe them. Look for a subsequent instalment in this series that discusses how options are used in hedging and factor into hedge accounting.

To highlight some of the complexities in option strategies, here is a small sample of those available on the London International Financial Future and Options Exchange (LIFFE).

- Long (and short) straddle
- Long (and short) strangle
- Long (and short) guts
- Long (and short) iron condor
- Long (and short) iron butterfly
- Long diagonal straddle calendar spread
- Long jelly roll
- Synthetic long (and short) underlying

For further help please contact:

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