

IFRS News

Shedding light on the IASB's activities*

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Issue of the month

IAS 23 amendments – a small change?

The IASB published amendments to IAS 23, Borrowing Costs last month. IAS 23 Revised requires capitalisation of borrowing costs, which is the same treatment as under US GAAP. This article explains the key features of IAS 23R, its implications for financial reporting and the actions management should take. By Shelley So and Dick Overeem.

The current version of IAS 23 provides management with a policy choice. Management can opt to capitalise borrowing costs relating to qualifying assets or expense the borrowing costs. IAS 23R removes this option and requires management to capitalise borrowing costs attributable to qualifying assets. Qualifying assets are assets that take a substantial time to get ready for their intended use or sale. An example is self-constructed assets such as buildings, machinery and internally developed software (intangible assets).

The changes to the standard were made as part of the IASB and FASB's short-term convergence project. The elimination of the option to expense borrowing costs does not achieve full convergence with US GAAP, as some technical differences remain. The effective date of IAS 23R is 1 January 2009, with earlier adoption encouraged. The amendments are to be applied prospectively; comparatives will not need to be restated.

The Board has provided additional relief by allowing management to designate a particular date on which it can start applying the amendments. For example, management can decide to designate 1 October 2008 as a starting date, because the company starts a project for which management would like to capitalise interest when it applies IAS 23R in 2009.

Key implications

- **Management no longer has an option to expense borrowing costs on qualifying assets.** The impact of this change depends on the current policy for borrowing costs. Companies already capitalising borrowing costs will not have much difficulty applying the change. They need, however, to be aware of a change that was made to the scope of IAS 23.
- **IAS 23R only applies to qualifying assets measured at cost.** Qualifying assets measured at fair value are outside the scope. This may have an impact on companies with investment properties, or companies with biological assets.

- **Inventories that are routinely manufactured, or otherwise produced in large quantities on a repetitive basis, are outside the scope of IAS 23R.** The current version of the standard only excludes such inventories if they are produced over a short period of time. Inventories like whisky and wine will no longer be eligible for capitalisation under IAS 23R.
- **Companies that expense borrowing costs under their current accounting policy must identify their qualifying assets.** Production companies often construct their own assets for use in the production process. Telecom companies often construct their own network. Qualifying assets can also appear in less obvious industries – for example, a retail company might build or redevelop its own stores. Other examples of qualifying assets are product development costs and implementation of new IT systems.

The capitalisation of borrowing costs on qualifying assets sometimes lead to practical questions, such as what are the qualifying assets? Over which period must management capitalise the borrowing costs? What general borrowings must be included in the determination of the capitalisation rate? This will be more complicated in group situations when different subsidiaries have qualifying assets and different borrowings (specific and general) at different rates. The standard recognises the difficulty and states that management must exercise judgment.

Remaining differences from US GAAP

IAS 23R does not eliminate all the differences between US GAAP and IFRS, but the most significant difference will be removed. The remaining differences are in the definitions of borrowing costs and

qualifying assets. For example, US GAAP does not allow exchange differences to be included; they are included in IAS 23R. Investments accounted for by the equity method may be qualifying assets under US GAAP; they are not qualifying assets under IAS 23R.

Actions to take now

IAS 23R is not mandatory until 2009 calendar years. Management should consider now:

- **Early adoption** – some companies will choose to adopt the new guidance early to align their IFRS and US GAAP reporting or may want to designate a particular date from when it will apply IAS 23R. Companies in the EU cannot adopt

IAS 23R until it has been endorsed.

- **Identification of qualifying assets** – companies must identify the assets for which it must start capitalising borrowing costs.
- **Determination of the appropriate borrowing cost** – companies must determine which specific borrowings and general borrowings are to be included in the calculation of the borrowing costs to be capitalised. They will also need to determine the capitalisation rate in the case of general borrowings.
- **Systems and controls** – the determination and computation of borrowing costs to be capitalised requires updates to information systems and controls.

Summary of IAS 23R requirements

- A qualifying asset is an asset that necessarily takes a substantial period of time to get ready for its intended use or sale.
- Borrowing costs are interest and other costs that an entity incurs in connection with the borrowing of funds. These may include:
 - interest on borrowings;
 - amortisation of discounts or premiums on borrowings;
 - amortisation of ancillary costs;
 - finance charges in respect of finance leases; and
 - exchange differences arising from foreign currency borrowings to the extent that they are regarded as adjustment to interest costs.
- An entity must determine which borrowings are to be allocated to the qualifying asset. In the case of specific borrowings, the borrowing costs of these specific borrowings less any investment income are capitalised as part of the cost of the qualifying asset.
- In the case of general borrowings, an entity must calculate a capitalisation rate based on the weighted average of the borrowing costs applicable other than the borrowings made specifically for the purpose of obtaining the qualifying asset.
- Commencement of capitalisation is the date when an entity incurs expenditures for the qualifying asset, incurs borrowing costs and undertakes activities that are necessary to prepare the assets for their intended use or sale. In case of suspension of activities during extended periods, an entity suspends capitalisation. An entity stops capitalisation of borrowing costs when substantially all the activities necessary are complete.

IAS 23R is applicable for periods beginning on or after 1 January 2009. Early adoption is encouraged, but this should be disclosed. IAS 23R will not be available to EU reporters until it has been endorsed by the EU.



Roundtable gives impetus to reconciliation timetable

The SEC hosted a roundtable last month to discuss progress on the Roadmap for convergence between IFRS and US GAAP. Representatives of many participants in the capital markets were on three panels. PwC partner in the US and Roundtable participant Dave Kaplan feeds back on discussions.

Last month's roundtable was a welcome initiative from the SEC, in which it demonstrated proactivity in moving the Roadmap forward. Foreign private issuers (FPIs) are keen to see an end to the requirement to reconcile IFRS financial statements with US GAAP. The SEC wants to understand the implications of the elimination of the reconciliation for the US capital markets, and has the protection of investors' interests at heart. It also recognises the importance of having the support of institutional investors, analysts, preparers, underwriters and underwriters' counsel, rating agencies, stock exchanges, academics and accountants – all of whom were represented at the Roundtable discussions.

The discussions were encouraging for FPIs. SEC chairman Christopher Cox in his opening remarks confirmed his commitment to the Roadmap and its objective of allowing FPIs to file financial statements in the US on an IFRS basis without reconciling to US GAAP. Chairman Cox also said that there was a possibility that US companies may ultimately have the same choice. There was unanimous support for arriving at a single set of global accounting

standards. To achieve this latter goal, some attendees supported moving to IFRS; others preferred continuing down the path of convergence.

This is the first time the SEC has talked openly about the considering that US companies might be allowed to apply IFRS instead of US GAAP. It is still early in the process, but this is at least recognition of a potential direction and is an important consideration toward achieving the long-term goal of a single set of global accounting standards.

Significantly, in favour of the US moving to IFRS was former SEC chief accountant Donald Nicolaisen. Speaking at the Roundtable, he said that IFRS

should be the financial reporting language of the US and, in the long term, mandatorily so.

He continued that companies would need to be given time to prepare for this change. The market would need to be educated – including users, preparers, analysts, accountants – as happened in Europe and is now taking place in Canada in its preparations for moving to IFRS in 2011.

Mr Nicolaisen's views will add impetus to the debate, which will continue. Proposals of how to achieve a common set of accounting standards may take different routes, but there is a clear desire to reach the same end result.

“Convergence will mean markets around the world can capitalise on the benefits of single set of global standards.... The commitment to converge the standards ... meant that [IFRS and US GAAP] could compete freely and operate side by side at least until the process of convergence resulted in actual convergence and there is truly one global accounting standard and international comparability.

It also meant that issuers markets and investors would have a choice because they, not the government, would decide between IFRS and US GAAP, and it meant the SEC was seriously contemplating a system where issuers, not only foreign but domestic issuers, would have that choice.”

Christopher Cox, SEC chairman

IFRS blog launched – <http://pwc.blogs.com/ifrs>

PwC senior IFRS partner, Ian Wright, has launched a blog on IFRS. He looks at financial reporting hot topics and the issues that companies need to think about before IASB 'ideas and proposals' become a practical reality.

The blog, updated about every 10 days, recommends how companies can contribute to shaping new standards under development at the IASB and how to get the best results when implementing new and amended standards.

'We need a lively debate on the emerging issues to help ensure that different perspectives on the impact of proposed changes are properly considered before new standards are implemented,' said Mr Wright. 'I am giving my views, and I'd be interested to hear people's feedback – a blog works best when it is interactive.'

If you'd like to receive email alerts when the blog is updated, email sarah.grey@uk.pwc.com

Q&As for the pharmaceutical sector

Claude Lopater, ACS partner in France, has produced a series of Q&As on financial reporting issues arising in a number of different areas. This article is based on the Q&As contributed by partners Jacques Denizéau and Philippe Vogt in PwC's Pharmaceutical Group in France. Additional guidance from PwC's global Pharmaceutical leader, Simon Friend.

Do IFRS financial statements provide a sensible basis for assessing the benefits of R&D programmes?

R&D accounting under IFRS is based on historical cost conventions; any increase in the underlying value of products in research and development (R&D) is not captured under IFRS. In addition, there are apparent inconsistencies between IFRS and US GAAP in the accounting for R&D that may make it difficult to interpret pharmaceutical entities' financial statements. Most R&D is expensed as incurred, but compounds, know-how and other intangibles that are acquired are capitalised, irrespective of their stage of development, and not amortised until they are available for use. This is typically the case when compounds are close to regulatory approval. Additional internal R&D expenditure that is incurred after the acquisition is expensed immediately; the acquired asset remains on the balance sheet at the acquisition cost and is tested for impairment.

Do IFRS financial statements allow preparers to capture fully the value and performance of a pharmaceutical group?

The valuation of a pharmaceutical group depends a lot on the value of its drugs and the potential of its portfolio of products under development. These arise from a number of sources, such as the acquisition of patents, R&D carried out internally or with another party, and the acquisition of a company that owns the patents.

These strategies, which are generally disclosed in the financial statements in a variety of ways, significantly impact the financial statements.

To be able to compare financial statements, analysts must understand:

- the impact on the IFRS accounts of acquisition or development strategies; and
- the main components of operating profit, restated to ensure clarity of financial communication.

For instance, financial statements prepared under IFRS will not provide information on the valuation of the pipeline of products in development where internally generated value is not capitalised.

How does IFRS allow users to see the value and performance of a pharmaceutical group?

The value of drugs on the market and those in development depends on their origin. They are recognised differently in the financial statements depending on whether they arise:

- from the acquisition of the patent from a third party;
- from the results of R&D carried out internally or in collaboration with a partner; or
- from the acquisition of the company that owns the rights to the drugs.

The comparison of pharma groups' balance sheet structures and the assessment of their performance can only be achieved by analysing the acquisition or development strategy of the drugs and by assessing the impact on the IFRS financial statements.

Performance of launched drugs can be assessed based on the information provided in the financial statements. However, in most cases, the financial statements do not capture the underlying value of the pipeline, which in many respects is the future of the business.

How do different acquisition and development strategies impact on the values of intangible assets?

The asset value of drugs in IFRS financial statements varies according to the following strategies:

- Patents acquired from third parties are recognised as amortisable intangible assets; their acquisition value reflects the fair value of their intellectual property at the date of acquisition. Internally generated drugs are recognised at a value lower than their market value. R&D costs are recognised in expenses. Internal development costs are capitalised only where a high degree of probability for regulatory approval has been reached for drugs in development. The basic development costs are not therefore recognised as assets but are expensed as they are developed.
- Drugs and ongoing R&D projects (regardless of their stage of development) that result from the acquisition of another company are recognised at fair value at acquisition date.

What components of operational profit do analysts need to focus on to understand performance?

R&D efforts

To understand R&D activity, users of financial statements must take into account not only costs recognised as expenses but also investments accounted for as assets, such as purchases of patents, either directly or indirectly through acquiring the company that owns the patent.

Amortisation of intangible assets

Users need to understand the impact of amortising patents on the operational

result. If the patents are acquired, their amortisation reduces the result over the period of their use. However, if the drugs are a result of R&D conducted internally and most of the costs have already been recognised in expenses, the total amortisation of the corresponding assets will be small, or even nil. Accounting policies should be examined carefully to assess company's policies for R&D accounting.

Impairment of intangible assets

Given the rapid development of the drugs market, impairment is an important factor to consider in estimating provisional cash flows.

The value of intangible assets can be significantly affected by competition from generic products, and by positions taken by health authorities on issues of pricing or reimbursement. All these issues have a direct effect on the future

profitability and company valuations.

These events may result in significant impairment charges in the income statement relating to products arising from the acquisition of rights and recognised on the balance sheet. It is therefore critical that the financial statements also provide evidence of the impact of generic competition and how sustainable value can be attributed to drugs with inherent 'brand' value.

This complexity in analysing IFRS financial statements justifies basing financial communication on reassessed performance indicators. Management should explain any adjustments and tie the explanations in with the financial accounting. Communications over pipeline progress is normally given in the business review sections and is critical to understanding the future of the company. However, it is largely divorced from the current financial results.

Accounting for milestone payments/receipts

Companies are increasingly entering into agreements that have complex accounting consequences. Readers of accounts should read the accounting policies and disclosures regarding agreements where there can be a material impact on revenue and cost recognition, potentially leading to income statement distortions.

Operating segments

The introduction of IFRS 8, Operating Segments, will provide the opportunity for pharmaceutical companies to better explain their performance through the eyes of management. There will be less focus on GAAP measures (unless they are used for internal reporting). The way businesses are run and the information used by the key decision-makers will drive segment reporting.



Korea to adopt IFRS

The Korean government and the Korea Accounting Standards Board (KASB) last month announced its roadmap for transition to IFRS in Korea. This marks the formal commitment for Korea to adopt IFRS into national GAAP by 2009. Kevin Kab Jae Lee in PwC's IFRS Centre of Excellence in Korea, and Seung-Kyoung Yoo in PwC's Global ACS Central team, explain.

Korea will adopt IFRS word-for-word into Korean GAAP. Minimal modifications within the IFRS framework, such as the deletion of certain alternatives, are being considered. This is similar to the Australian model of IFRS adoption. The process will be implemented in two phases, shown in the table overleaf.

Companies must make disclosures about the impact of IFRS on their financial statements in the year before they adopt IFRS.

The KASB will issue the Korean version of the main body of IFRSs and IFRICs by the second half of 2007. It will issue the Korean version of the Basis of Conclusions and Implementation

Adopting IFRS as national GAAP will enhance comparability of accounting standards and relieve the burden of converting financial statements based on Korean standards to IFRS for globally listed companies. Korean companies listed in the US will also benefit from the elimination of the US GAAP/IFRS reconciliation requirement.

Guidance by 2008 to help users understand the main body and facilitate the application.

The roadmap proposes that the consolidated financial statements, including quarterlies, are disclosed as primary financial statements. Separate financial statements are currently the main source of financial information; consolidated financial statements are supplementary.

All listed companies are required to apply the standards from 2011. Listed companies whose asset value is less than 2 trillion Korean Won (approximately US\$2 bn) are exempt from disclosing the quarterly financial statements on

Presentation of income under IFRS

PricewaterhouseCoopers' has published a survey of presentation of non-GAAP measures in the income statement.

The financial statements of 2,800 companies were surveyed, specifically looking at the additional income measures companies included in their financial statements beyond the minimum required by IFRS. The survey also examined how companies present these non-GAAP measures in their income statements.

“Investors tell us that additional income measures are useful and that they take them into account when making investment decisions,” says Leandro van Dam, PwC partner in the Netherlands and co-sponsor of the survey. “They are also looking for non-GAAP measures that management uses to run the business. They want consistency of information over time and comparability among companies.”

Debate on the use of non-GAAP measures is gathering interest. The IASB and FASB are considering financial statement presentation in a joint project. Some highlights from the report are summarised below.

A bridge from old to IFRS

Companies have aligned their choice and presentation of non-GAAP measures

under IFRS as much as possible with what they reported under national GAAP. This has allowed users to compare non-GAAP measures calculated using IFRS recognition and measurement principles with the measures calculated on the previous basis.

No evidence of cherry-picking

Companies do not appear to have cherry-picked additional income measures to show their results in a more positive light; the overall trends (rise or fall) for the alternative income measures reported were similar to the trends for net profit under IFRS. Companies generally met IFRS presentation requirements for the income statement.

Industry variations

Industry variations in EBITDA and similar measures are consistent between 2004 reporting under national GAAP and 2005 IFRS reporting. Companies already appear to be responding to investor demands for international comparability within industry sectors.

National trends are still strong

Countries that have historically reported

certain non-GAAP measures still do so under IFRS; those that did not report specific non-GAAP measures did not start to do so.

International comparability of non-GAAP reporting in the first year of application was unlikely to arise spontaneously. Management had little opportunity to compare reporting practices with their peers and limited experience of IFRS-related discussions with investors, regulators and other parties. Many conferences and industry sessions focused on recognition and measurement and paid little attention to format requirements and options for additional line items in the income statement. There was therefore no real platform for development of market norms.

Companies may find the research useful in deciding what to communicate to the market in next year's IFRS financial statements. “This research should enable management to look at what peers are doing,” says Leandro, “and consider whether current diversity of non-GAAP measurement and presentation holds any clues for better ways of communicating with investors in future.”

Download the PDF from pwc.com/ifrs

For further help, please contact:

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