

# IFRS News

Shedding light on the IASB's activities\*

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## IFRS 3 and IAS 27 amended

The IASB has agreed to amend its standards on business combinations and consolidated financial statements as part of the IFRS/US GAAP convergence programme. The decision to approve the amendments was made at the end of June; the IASB will publish its amendments early September. The FASB is also expected to amend its standards on business combinations and consolidated financial statements. Mary Dolson looks at the nature of the changes for users of IFRS.

The business combinations standard (IFRS 3R) is expected to be identical in principles and language to the FASB's 141R with three exceptions: full goodwill, reacquired rights and the requirements around recognition of contingent assets and contingent liabilities. This is expected to eliminate almost all of the current differences in the initial accounting for business combinations. Significant differences will remain in subsequent accounting, driven by different requirements for impairment testing, accounting for contingent assets and liabilities and deferred tax.

The consolidation standard (IAS 27R) is expected to be converged in the broad principles, but the standards have not been developed using the same language. Differences are expected to remain mainly from the operation of de facto control and FIN 46 and SIC-12.

### Changes to IFRS 3

#### *Scope and applicability of IFRS 3R*

The business combinations standard represents some significant changes for IFRS but is less of a radical change than the comparable standard in US GAAP. IFRS 3R is a further development of the acquisition model. The standard now applies to more transactions, as combinations by contract alone and combinations of mutual entities are brought into the scope of the standard. Common control transactions and the formation of joint ventures remain outside the scope of the standard. The definition of a business has been amended slightly to include the phrase 'capable of being managed' rather than 'are managed'. This change is not predicted to pull many more transactions into business combinations from asset deals. Acquisition date does not change under IFRS; US GAAP will converge to the existing requirements of IFRS on this point.

#### *Consideration*

Consideration is the amount paid for the acquired business. Some of the most significant changes are found in this section of the revised standard and will have the effect of both increasing and decreasing the amount of consideration. Transaction costs no longer form a part of the purchase price, they are expensed as incurred. Consideration now includes the fair value of all interests that the acquirer may have held in the acquired business. This includes any interest in an associate or joint venture, option, warrants or other equity interests of the acquired business. If the interests in the target were not held at fair value,

the interest is re-measured to fair value with the change recognised in the income statement.

The requirements for recognition of contingent consideration have also been amended. Contingent consideration is now required to be recognised at fair value even if it is not deemed to be probable of payment at the date of the acquisition. All subsequent changes in contingent consideration are recognised in the income statement, rather than against goodwill as today.

#### **Goodwill and measurement of non-controlling interests**

The requirement to recognise 'full goodwill' in a business combination where the acquirer obtains a controlling interest but not 100% of the acquired business was one of the more controversial proposals in the exposure draft. The revised standard gives entities the option to measure non-controlling interests (previously minority interest) at fair value of identifiable assets and liabilities or at full fair value. The first will result in measurement of goodwill, little different from existing IFRS 3; the second approach will record goodwill on the non-controlling interest as well as the acquired controlling interest. The 'bargain purchase' guidance remains the same, with the requirement to recognise 'negative goodwill' immediately in the income statement.

#### **Asset and liability recognition**

The revised IFRS 3 has limited changes to the assets and liabilities recognised in

the acquisition balance sheet. The existing requirement to recognise all of the identifiable assets and liabilities of the acquiree is retained. Most assets are recognised at fair with exceptions for certain items such as deferred tax and pension obligations. There is a new requirement to recognise assets subject to contingencies at fair value, similar to the existing guidance to recognise contingent liabilities at fair value. There is additional guidance on how to determine whether the assets and liabilities belong to the acquired business or are excluded from the acquisition balance sheet.

The revised standard includes additional guidance with regard to contracts and arrangements of the acquired business at the transaction date. These are assessed for classification purposes at the transaction date with the exception of leases and insurance contracts. Leases and insurance contracts are assessed based on the facts at the time they were entered into (or subject to substantial modification). All other contracts are assessed at the date of the acquisition.

#### **Other changes**

There is additional guidance on accounting for employee shared-based payments in the revised standards. It provides additional specificity on valuation, as well as determination of whether replacement share awards are part of the consideration for the business combination or may be compensation for post-combination services.

The period of time to finalise the purchase accounting remains one year from the date of the transaction.

Current guidance requires deferred tax assets of the combined business that are not recognised at the date of the combination but subsequently to meet the recognition criteria to be adjusted against goodwill. The revised standard will only allow adjustments against goodwill within the one year window for finalisation of the purchase accounting.

#### **Changes to IAS 27**

The revised consolidation standard moves IFRS to a mandatory adoption of the economic entity model. Current practice under IFRS is overwhelmingly the parent company approach. The economic entity approach treats all providers of equity capital as shareholders of the entity, even when they are not shareholders in the parent company.

A partial disposal of an interest in a subsidiary in which the parent company retains control does not result in a gain or loss but an increase or decrease in equity. Purchase of some or all of the non-controlling interest is treated as a treasury share-type transaction and accounted for in equity. A partial disposal of an interest in a subsidiary in which the parent company loses control but retains an interest (say an associate) triggers recognition of gain or loss on the entire interest. A realised gain or loss is recognised on the portion that has been disposed of; a holding gain is recognised on the interest retained, calculated as the difference between the fair value and the book value of the retained interest.

#### **Conclusion**

The revised standards bring a further iteration of the acquisition accounting model and compulsory adoption of the economic entity approach. The Board has promised 'there is no phase 3' but is expected to consider the accounting for common control transactions and puts, calls and forwards (in a business combination) as potential improvements projects.

### **PwC publishes Q&A guide to business combinations**

'IFRS 3R: Impact on earnings – the crucial Q&A for decision-makers'

- 20-page guide aimed at finance directors, financial controllers and deal-makers
- Background to the new standard
- Impact, including on the financial statements and on controls
- Questions and answers
- Summary of differences with US GAAP
- Summary of differences between old and new standards

Due for release in September 2007. Contact [michael.w.gaul@uk.pwc.com](mailto:michael.w.gaul@uk.pwc.com) for more information.

# Accounting for ‘self-generated’ CERs

The article ‘Carbon Emission Reduction certificates’ in last month’s edition of IFRS News explained the background to CERs and the ‘Clean Development Mechanism’. This month, Valerie Ribollet Pham Van Ba and Patrick Fiaux from PwC’s Global Accounting Consulting Services group look at the accounting for self-generated carbon emission reduction certificates (CERs) by ‘green’ entities in fast-growing economies.

CERs represent a unit of greenhouse gas reduction that has been generated and certified by the United Nations under the ‘Clean Development Mechanism’ (CDM) provisions of the Kyoto Protocol. Examples of projects include reforestation schemes and investment in clean energy technologies.

The entity that receives the CER certificates can trade or sell them to other entities, or may use them to fulfil a company or group’s requirements as part of the EU emissions trading scheme.

The key question that drives the accounting for self-generated CERs by ‘green’ entities is, what is the nature of the CERs? The answer to this question

lies in the specific circumstances of the green entity’s core business and processes. If the CERs generated are held for sale in the entity’s ordinary course of business, CERs are within the scope of IAS 2. If they are not, they should be considered as identifiable non-monetary assets without physical substance. They are therefore intangible assets.

The accounting for CERs is also driven by the applicability of IAS 20, Government Grants and Disclosure of Government Assistance. Management needs to assess if CERs are granted by government. If they are, and depending on the classification above, there are two alternative accounting approaches

available to the entity. These approaches are summarised in the table below.

## Conclusion

PricewaterhouseCoopers’ survey on the accounting for EU Emissions Trading Schemes and CER certificates, *Trouble-entry accounting – uncertainty in accounting for the EU Emissions Trading Scheme and Certified Emissions Reductions*, looks at the accounting practices of 26 organisations in a range of industries and countries around the world. For more information on the survey, contact [richard.french@uk.pwc.com](mailto:richard.french@uk.pwc.com) or [jonathan.a.rose@uk.pwc.com](mailto:jonathan.a.rose@uk.pwc.com), or visit [www.pwc.com/energy](http://www.pwc.com/energy).

Based on the assumption that the ‘self-generated’ CERs are granted by a government as defined in IAS 20, the two key approaches we consider suitable under IFRS are as follows. This table will not apply if the CERs are not granted by a government as defined by IAS 20.

	<b>A. Treat as government grant with CERs recognised as inventory under IAS 2</b>	<b>B. Treat as a government grant with CERs recognised as an intangible under IAS 38</b>
When should CERs be recognised?	<p>CERs are produced over the course of the project. However they are not received by the producing entity until the project and the associated emissions reductions meet the conditions of the grant and are verified by the CDM executive board.</p> <p>CERs should therefore only be recognised once there is reasonable assurance that the CERs will be received (i.e. reasonable assurance that the conditions attaching to the attribution of the CERs are met) – these conditions may be met as the entity produces the ‘green product’ (i.e. upon ‘generation’) or may require fulfilment of other conditions attached to receiving the CERs.</p>	<p>CERs should meet the definition of intangible assets: identifiability, control over the resources and future economic benefits criteria should be met.</p> <p>CERs should be recognised:</p> <ul style="list-style-type: none"> <li>• when there is a reasonable assurance that the entity will comply with the conditions attached to the CERs and the grants will be received; and</li> <li>• if the cost of the CER can be measured reliably and it is probable that the expected future economic benefits that are attributable to the CER will flow to the entity.</li> </ul> <p>As approach A, this may mean the CERs are recognised upon ‘generation’ or at a later point in time.</p>

	<b>A. Treat as government grant with CERs recognised as inventory under IAS 2</b>	<b>B. Treat as a government grant with CERs recognised as an intangible under IAS 38</b>
What value should be ascribed to CERs that have been recognised – at initial measurement?	<p>IAS 20, Accounting for Government Grants and Disclosure of Government Assistance, provides two choices in terms of initial measurement:</p> <ul style="list-style-type: none"> <li>• nominal amount – production costs should be allocated on a rational and consistent basis between production cost of the 'green product' if relevant and costs of production of the CERs.</li> <li>• fair value – CERs should be recognised at fair value and a government grant recognised for the difference between nominal amount and fair value.</li> </ul>	As approach A.
What value should be ascribed to CERs that have been recognised – subsequent measurement	Subsequently, the CER inventory should be valued at the lower of the cost and net realisable value.	<p>If CERs do not meet the definition of 'non-current assets held for sale' then they should be held at cost less any amortisation and impairment, if there is no active market. Where there is an active market for CERs, IAS 38 permits valuing them either at cost less any amortisation and impairment or at fair value. Increases and decreases in the carrying amount of the CERs should be recognised as required by IAS 38.85 and IAS 38.86.</p> <p>Where CERs meet definition of 'non-current assets held for sale' per IFRS 5 (CERs should be immediately available for sale in its present condition and the sale is highly probable), the following treatment applies:</p> <ul style="list-style-type: none"> <li>• treatment per IAS 38 should continue to apply up until the date at which CERs meet IFRS 5 criteria. Impairment test under IAS 36 should be performed.</li> <li>• subsequently, CERs should be held at lower of their carrying amount and fair value less cost to sell.</li> </ul>
Amortisation and impairment	Not applicable. CER inventory should be valued at lower of the cost and net realisable value.	<p>CERs are deemed to have a useful life. Amortisation is therefore applied. In accordance with IAS 38, there is no residual value to CERs unless there is an active market. Consequently:</p> <ul style="list-style-type: none"> <li>• where there is an active market for CERs no amortisation is recognised as the residual value will be the same as cost and hence the depreciable amount will be zero; and</li> <li>• where there is no active market, CERs are assumed to have no residual value.</li> </ul> <p>Management should develop an appropriate amortisation method and justify the basis for anything other than straight line amortisation.</p> <p>The CERs should be tested for impairment under IAS 36. When CERs are under IFRS 5 scope, there is no amortisation. IFRS 5 measurement principles apply.</p>

	A. Treat as government grant with CERs recognised as inventory under IAS 2	B. Treat as a government grant with CERs recognised as an intangible under IAS 38
When should income associated with CERs be recognised?	When the grant is measured at nominal amount, no income can be recognised before the date of the actual sale of the CERs. When the grant is recognised at fair value, the grant is recognised as other income but at initial recognition. Consequently there is a timing difference of recognition of income if CERs are recognised at nominal amount or at FV under IAS 20.	As Approach A
Presentation in the income statement	CERs initial recognition is recorded as 'other income'. At disposal date, the sale of CERs is also recognised as 'other income'. An alternative presentation is: <ul style="list-style-type: none"> <li>• at initial recognition, the company reduces the cost of sales to reflect the negative cost of the subproduct,</li> <li>• at disposal date, the company recognises revenue for the amount of the sale, and cost of sales for the carrying amount of the CER.</li> </ul>	CERs initial recognition is recorded as 'other income'.  At disposal date, the sale of CERs is recognised as 'other income'.

## New appointments at IFRIC

Four new members have been appointed to the International Financial Reporting Interpretations Committee with effect from 1 July:

- Guido Fladt, head of the technical IFRS function in PwC, Germany;
- Bernd Hacker, Head of Standard Setter Liaison and Financial Instruments Accounting Policies at Siemens in Germany;

- Darrel Scott, head of Group Finance, FirstRand Banking Group in South Africa; and
- Andrew Vials, KPMG's partner in charge of the UK firm's Department of Professional Practice, Accounting and Reporting.

The appointments are for three years.

The new members replace outgoing members PwC's IFRS leader, Ian Wright,

and Jeannot Blanchet, Domingo Marchese and Mary Tokar.

IFRIC is considering expanding membership from 12 to 14 and is currently seeking comments on the proposal.

An interview with Guido Fladt will be published in the September edition of *IFRS News*.

### IFRS for SMEs (proposals) – Pocket guide 2007

This new PricewaterhouseCoopers publication provides a summary of the recognition and measurement requirements in the proposed 'IFRS for Small and Medium-Sized Entities'.

It is written for those who have little or no knowledge of full IFRS, but who have an understanding of basic accounting concepts and terminology.

'Small and medium-sized entities' has different

meanings in different territories. The definition is based on the nature of the entity not its size. The standard will apply to entities that publish general purpose financial statements for their owners and the local tax authorities, not to entities with securities traded in a public market or that hold assets in a fiduciary capacity.

To order your copy, contact your local PwC office or order online at [www.cch.co.uk/ifrsbooks](http://www.cch.co.uk/ifrsbooks)



## IASB project timetable

Project	ED published/ expected	Comment deadline	Standard published/ expected
<b>Business combinations and related issues (FASB and IASB joint project)</b>			
– IFRS 3, Phase 2: application of purchase method	12 July 2005	28 October 2005	Q3, 2007
– Minority interests: amendment to IAS 27	12 July 2005	28 October 2005	Q3, 2007
<b>Convergence</b>			
– IAS 37	12 July 2005	28 October 2005	Some time in 2008
– IAS 12, Income Taxes	Q4, 2007	Undecided	Some time in 2008
– Amendment to IAS 20, Government Grants	Deferred until IAS 37 finalised	Undecided	Undecided
– IAS 23, Borrowing Costs	25 May 2006	29 September 2006	29 March 2007
– IAS 31, Joint Ventures	Q3, 2007	Undecided	Some time in 2008
– Amendment of IAS 33, Earnings per share	Q3, 2007	Undecided	Some time in 2008
– Impairment	Active project	Undecided	Undecided
<b>IAS 32 – Financial Instruments Puttable at Fair Value and Obligations arising on Liquidation</b>	22 June 2006	23 October 2006	Q3, 2007
<b>Amendment to IAS 24, Related Party Disclosures</b>	22 February 2007	25 May 2007	Some time in 2008
<b>Fair value measurement guidance</b>	Discussion paper in Q4, 2006. ED expected some time in 2008	DP 6 May 2007. ED undecided	Undecided
<b>IFRS 2 amendments – vesting conditions and cancellations</b>	2 February 2006	2 June 2006	Q3, 2007
<b>Consolidation (including SPEs)</b>	Discussion paper expected in Q1 2008. ED expected some time in 2008	Undecided	Undecided
<b>IAS 1, Presentation of Financial Statements – Segment A</b>	16 March 2006	17 July 2006	September 2007
– Segment B	Discussion paper due Q4, 2007. ED expected some time in 2008	Undecided	Undecided
<b>Revenue and related liabilities (FASB and IASB joint project)</b>	Discussion paper expected in Q1 or Q2, 2008	Undecided	Undecided
<b>Emission rights</b>	Undecided (depends on IAS 20)	Undecided	Undecided
<b>IFRS for SMEs</b>	15 February 2007	1 October 2007	Q3 or Q4, 2008
<b>IFRS 4, Insurance Contracts – phase 2</b>	Discussion paper issued 3 May 2007. ED expected some time in 2008	Undecided	Undecided
<b>Leases – joint project with UK ASB</b>	Discussion paper in Q2 2008	Undecided	Undecided
<b>First-time adoption: cost of investment in subsidiary (IFRS 1)</b>	25 January 2007	27 April 2007	Q4, 2007
<b>Post-retirement benefit (including pension) – IASB only</b>	Discussion paper in Q4 in 2007	Undecided	Undecided
<b>IAS 39, Financial Instruments (replacement of existing standards)</b>	Discussion paper in Q4 in 2007	Undecided	Undecided
<b>IAS 39, Financial Instruments: Liabilities and equity – phase 2</b>	Discussion paper in Q3 in 2007	Undecided	Undecided
<b>IAS 39, Financial Instruments: portions</b>	ED expected in Q3, 2007	Undecided	Undecided
<b>Extractive activities</b>	Discussion paper sometime in 2008	Undecided	Undecided
<b>Annual improvement project</b>	ED expected in Q4	Undecided	Undecided

Note: these dates are provisional only and subject to change

## IFRIC project timetable

Project	ED published/ expected	Comment deadline	Interpretation published/ expected
D19, IAS 19 – The Asset Ceiling: Availability of Economic Benefits and Minimum Funding Requirements (IFRIC 14)	24 August 2006	31 October 2006	5 July 2007
D20, Customer Loyalty Programmes (IFRIC 13)	7 September 2006	6 November 2006	28 June 2007
D21, Real Estate Sales	5 July 2007	5 October 2007	2008

Note: these dates are provisional only and subject to change

### For further help, please contact:

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