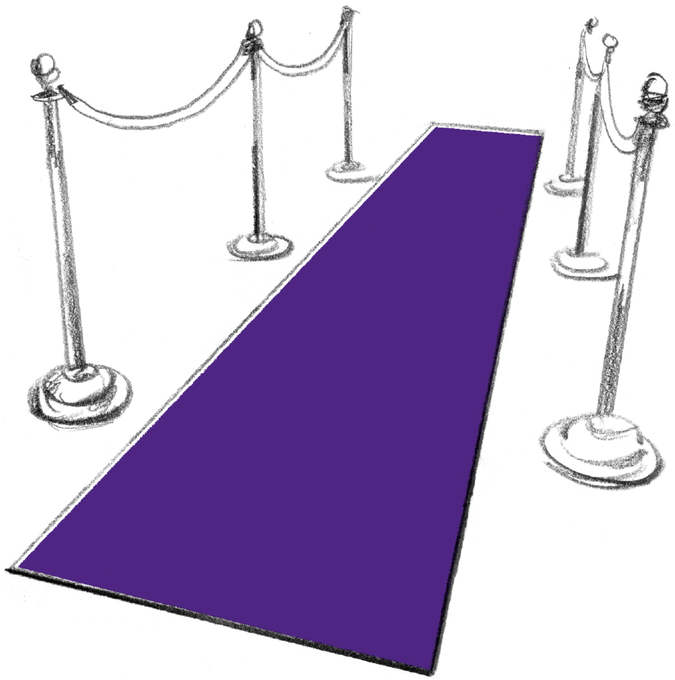
Grant Thornton

IFRS News

Welcome to IFRS News – a quarterly update from the Grant Thornton International IFRS team. IFRS News offers a summary of the more significant developments in International Financial Reporting Standards (IFRS) along with insights into topical issues and comments and views from the Grant Thornton International IFRS team.

This first edition leads with the International Accounting Standards Board's (IASB) revised standards on business combinations which will make major changes to the reporting of merger and acquisition activity around the world. We then look at some other recent changes that have taken place and some that are expected to occur in the near future.



New standard on business combinations

Revised versions of IFRS 3 and IAS 27 complete the second phase of the IASB's business combinations project

On 8 January 2008 the IASB published a revised version of IFRS 3 'Business Combinations' (IFRS 3R) and an amended version of IAS 27 'Consolidated and Separate Financial Statements' (IAS 27), marking the completion of the second stage of its business combinations project.

The revised Standards, which are effective for combinations in accounting periods beginning on or after 1 July 2009, make significant changes to the accounting for business combinations and also address a number of gaps in the old Standards. The most notable changes are to the accounting for step and partial acquisitions and the treatment of acquisition costs and non-controlling interests. The text opposite summarises these changes.

IFRS 3R is also significant for being the first major new Standard to have been produced jointly with the US Financial Accounting Standards Board (FASB). Indeed, in publishing equivalent standards to IFRS 3R and IAS 27, the FASB has made fundamental changes to the way in which business combinations are currently accounted for in the US. The two Boards did however reach different conclusions in a few areas with the result that IFRS 3R and the equivalent new US Standard (SFAS 141 (Revised 2007)) are not identical. The goal of international convergence of accounting standards is certainly nearer but lack of agreement on some issues demonstrates that challenges lie ahead.

Step and partial acquisitions

Goodwill in a business combination is determined only at the acquisition date (the date when control is obtained) under IFRS 3R.

This means that it is no longer necessary to "fair value" every asset and liability at each step in an acquisition that is achieved in stages to calculate goodwill. Goodwill is now determined once based on conditions at the acquisition date – the date control is obtained.

Related changes to IAS 27 affect part disposals of shares in a subsidiary and purchases of shares held by non-controlling interests. These will now be accounted for as equity transactions. No income statement gain or loss will be recorded and no adjustment will be made to goodwill on such a transaction.

Acquisition costs

Acquisition costs, such as lawyers' fees, will no longer be capable of being capitalised but must be expensed in the income statement. The IASB's intention behind the change is to increase transparency and comparability but it seems doubtful that companies will welcome the impact of the change on their reported results.

Non-controlling interests

Non-controlling interests (previously called minority interests) in the acquiree can be measured either at (i) fair value; or (ii) the proportionate interest in the identifiable net assets. If fair value is used, the effect is that 100% of the goodwill of the acquiree is recognised even if the parent's interest in the acquiree is less than 100% (this is sometimes referred to as the "full goodwill" method).

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IASB consolidation project continues to evolve

Started in 2003, the IASB's consolidation project continues to progress. The goal of the project is to publish a single IFRS that will establish the control criteria to be applied to all entities, so replacing IAS 27 'Consolidated and Separate Financial Statements' and SIC 12 'Consolidation - Special Purpose Entities'.

The consolidation of structured entities such as special purpose entities has been a topical issue in recent months due to the effects of the current credit crunch, and may have been a factor in the IASB's decision to discuss a proposed approach to consolidation of such entities in its November 2007 meeting. The approach proposed in that meeting would focus on a 'single control model' as opposed to a 'risks and rewards' one, although control would often be assessed through an analysis of risks and rewards.

With the Board expecting to issue a discussion paper in the second half of 2008, this project is certainly one to watch.

IFRS 2 amendment to impact Save As You Earn schemes

In January 2008 the IASB also issued its amendment to IFRS 2 'Share-based Payment: Vesting Conditions and Cancellations'. The amendment changes the definition of vesting conditions which will be restricted to service conditions and performance conditions. It also introduces the term "non-vesting conditions". Non-vesting conditions are requirements that are not service or performance conditions, but which have to be met in order for the counterparty (eg the employee) to receive the share-based payment. These conditions must be taken into account in measuring the grant date fair value of the equity instruments granted.

The amendment also requires that when either the entity or a counterparty can choose whether a non-vesting condition is met, failure to meet that non-vesting condition is to be treated as a cancellation. IFRS 2 requires that a cancellation is accounted for as an acceleration of vesting – the amount that would have been spread over the remainder of the vesting period is expensed immediately. The amendment will therefore have a significant impact on some companies' results.

A common example of a non-vesting condition is an employee share option scheme under which the employee has to make regular contributions into a savings account during the vesting period. These funds are then used to exercise the options. Consequently, any such schemes (sometimes known as Save As You Earn or SAYE schemes) should be reviewed carefully for the impact of this amendment. Accounting systems may need to be amended to track the savings record of all employees in the scheme to ensure cancellations are identified and accounted for in accordance with the new requirement.

> Schemes should be reviewed carefully for the impact of this amendment, accounting systems may need to be amended.

The changes are effective for accounting periods beginning on or after 1 January 2009 and will be applied retrospectively.

IASB toughens up on IFRS 2 avoidance

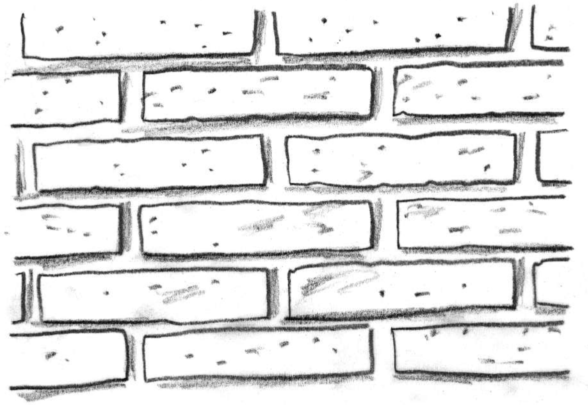
The IASB has published an Exposure Draft of proposed amendments to IFRS 2 'Share-based Payment' and IFRIC 11 'IFRS 2 – Group and Treasury Share Transactions' in an attempt to crack down on opportunities to structure share-based payment plans to fall outside IFRS 2's scope.

More specifically, the proposed amendments specify the accounting by an entity that receives goods or services from its suppliers (including employees) for which the parent (or another group entity) makes cash payments that are share-based. For example:

- Arrangement 1 – the suppliers of the entity will receive cash payments from the parent that are linked to the price of the equity instruments of the entity
- Arrangement 2 – the suppliers of the entity will receive cash payments from the parent that are linked to the price of the equity instruments of the parent of the entity.

Under either arrangement, the parent of the entity has an obligation to make the required cash payments to the suppliers of the entity but the entity itself does not have any obligation to make such payments to its suppliers or provide them with equity instruments.

The proposed amendment to IFRS 2 clarifies that an entity that receives goods or services from its suppliers must apply IFRS 2 even though the entity has no obligation to make the required share-based cash payments. In other words, a share-based payment expense is not avoided by arranging for another group entity to settle the obligation.



Amendment to IAS 32 departs from principles

IASB acts to correct counter-intuitive results but departs from principles

In February 2008 the IASB issued an amendment to IAS 32 'Financial Instruments: Presentation' addressing particular types of financial instrument. Its effect will be to change the classification of limited types of instrument from liability to equity.

Prior to the amendment, IAS 32 required any financial instruments that the holder can require the issuer to redeem to be classified as a liability. This principle works well in most situations. However, some entities such as partnerships and co-operatives typically issue only puttable instruments. These instruments may be redeemed for a proportionate share of the entity's net assets and are often subordinated to other claims on the entity's assets. Economically, these seem equity-like and the amendment aims to reflect this. Equity classification is however subject to a number of strict criteria – a careful evaluation of each instrument's terms will be necessary.

The amendment also addresses instruments that impose on the entity an obligation to deliver a pro-rata share of the net assets of the entity only on its liquidation.

Counter-intuitive outcomes

The existing requirements of IAS 32 can lead to counter-intuitive outcomes for puttable instruments – for instance, strong financial performance by the issuer can increase the value of such an instrument so that reported liabilities and finance costs also increase. In this sense, the amendment provides relief, as such instruments will be classified as equity provided they have particular features and meet specific conditions. However these conditions essentially amount to a list of rules that is both narrowly focused and complex, and represent a departure from the principles-based standards that IFRS purports to aspire to. Our concern is that a rules-based approach is not the right direction for the future development of the Standard, and we therefore encourage the IASB to bear this in mind as it considers how to revise the Standard in light of its Discussion Paper on how to improve and simplify the current requirements (see separate article).

IASB seeks a new approach to debt-equity classification

The IASB has taken its first due process step towards a new Standard to replace IAS 32 'Financial Instruments: Presentation' by issuing a Discussion Paper entitled 'Financial Instruments with Characteristics of Equity'.

The Discussion Paper is part of a joint project between the IASB and the US Financial Accounting Standards Board (FASB). The FASB has led the research phase of this project, issuing its own paper which the IASB has published together with its own introduction.

The Discussion Paper has been issued in response to criticisms that the principles in IAS 32 are both difficult to apply and can result in inappropriate classification of some financial instruments. While the IASB has responded to some of these criticisms by issuing an amendment to IAS 32 for puttable instruments and obligations arising on liquidation (see above) it believes there is a case for a brand new model. The Discussion Paper discusses the advantages and disadvantages of three alternative approaches to the question of how to draw the line between equity instruments and financial liabilities.

At this early stage the FASB favours a more restrictive 'basic-ownership instrument' view of equity. The IASB has not yet reached any view of its own but has issued the Discussion Paper to solicit views on whether the FASB's proposals are a suitable starting point for its deliberations.

The Discussion Paper can be downloaded from the IASB's website: **www.iasb.org**.

Comment:

As noted in our separate article on the recently issued amendment to IAS 32 dealing with puttable financial instruments and obligations arising on liquidation (see 'Amendment to IAS 32 departs from principles'), we do not wish to see the requirements on determining the classification of financial instruments degenerate into a list of complicated rules. We therefore encourage the IASB to ensure the development of any revised Standard is firmly based on strong principles.

Distributing non-cash assets to owners

The International Financial Reporting Interpretations Committee (IFRIC) has published a draft Interpretation containing proposed guidance on how a company should measure distributions of assets other than cash to its owners (sometimes referred to as 'in specie dividends' or 'dividends in kind').

D23 'Distributions of Non-cash Assets to Owners' proposes that obligations to make non-cash distributions should in effect be measured based on the fair value of the assets distributed. When the distribution is made any difference between the obligation and the assets' carrying value would be recognised in profit or loss. The Interpretation would apply to all such distributions with the exception of distributions to another entity in the same group. The IFRIC proposes that the new rules should be applied prospectively, acknowledging the difficulty companies would have in recognising past distributions at their fair values.

Accounting for customer contributions

The International Financial Reporting Interpretations Committee (IFRIC) has published a draft Interpretation containing proposed guidance on how to account for customer contributions.

Customer contributions are transactions in which a company receives an asset that is used to provide access to an ongoing supply of goods or services to customers. In some cases, the asset that is received is cash that is then used to buy or construct the asset. These arrangements are common in the utilities sector in many countries. For example, a property developer might be required by law to pay for new utility infrastructure associated with new housing developments and then donate the infrastructure assets to the utility supplier.

IFRIC D24 'Customer Contributions' addresses whether a customer contribution should be recognised as an asset and, if so, at what value. It then goes on to discuss how to account for the credit that would arise from the recognition of such an asset and how to account for a cash contribution.

Under the proposals, companies receiving contributions from customers will be required to recognise contributed assets and revenue over the period that the relevant access is provided. Some access providers that have not previously recognised contributed assets will recognise increased property, plant and equipment and revenue. The proposals would also mean that those access providers that have recognised revenue immediately on receipt of a contributed asset would need to in future defer it over a longer period. However, as the proposal is that the final Interpretation would be applied prospectively there will be no need to restate prior periods for this change in approach.

The pensions debate heats up

The financial reporting of pensions has been a controversial topic in recent years, even making the evening news in some countries. As the IASB looks to review its current Standard on this subject, IAS 19 'Employee Benefits', the European Financial Reporting Advisory Group (EFRAG) and several European standard-setters have published a Discussion Paper which seeks to influence the debate.

The development of the paper, 'The Financial Reporting of Pensions', has been led by the UK Accounting Standards Board and suggests that changes in pension assets and liabilities should be reported in the period in which they arise, rather than being spread over a future period. It also proposes that the financial statements should reflect the actual return on assets, rather than the expected value as is currently required. Both proposals seek to reflect the underlying economic reality but will have the side-effect of increasing the volatility of reported results compared to the smoothing mechanisms which are currently used by many companies.

The paper suggests that changes in pension assets and liabilities should be reported in the period in which they arise, rather than being spread

The Discussion Paper also suggests that liabilities should be measured using a risk-free rate rather than the high-quality corporate bond rate that is currently required by IAS 19. This proposal may also prove unpopular with companies, as a reduced discount rate will increase the size of reported pension liabilities. The Discussion Paper is not of course an IASB document and the IASB may take a quite different direction as it develops its own views. Nevertheless the Discussion Paper can be expected to have some influence on the debate.

The paper suggests that changes in pension assets and liabilities should be reported in the period in which they arise, rather than being spread.

Revised proposals for determining the cost of an investment

IASB Exposure Draft aims to reduce barrier to adopting IFRS in separate financial statements

Proposed changes to IFRS 1 'First-time adoption of International Financial Reporting Standards' aim to address concerns over the difficulty of retrospectively determining the cost of a subsidiary as defined in IAS 27 on first time adoption of IFRS. This issue has been a factor in discouraging entities from adopting IFRS in their separate financial statements. The Exposure Draft is unusual in that it was developed in response to comments received on an earlier Exposure Draft published in January 2007. The Board's original proposals were not seen as doing enough to rectify the problem they were intended to address.

The Exposure Draft proposes to allow an entity, at its date of transition to IFRS in its separate financial statements, to use a deemed cost to measure an investment in a subsidiary, jointly controlled entity or associate. Under the proposals an entity may choose either the fair value or the previous GAAP carrying amount of the investment as the deemed cost of such investments.

A pragmatic solution

While there is no clear principle behind these proposals, they do offer a pragmatic solution that will encourage more entities to use IFRS in their separate financial statements. Given that the issue arises only on first time adoption of IFRS, it seems to us to be a compromise worth living with.

In the news: large firms' joint paper on principles-based accounting

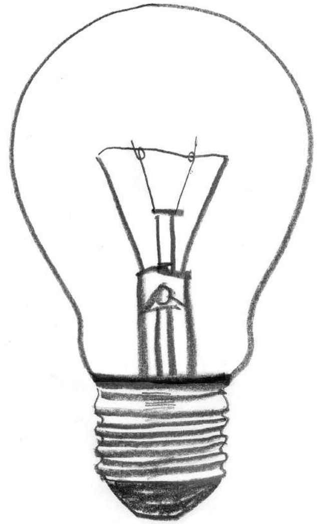
Widespread support for a principles-based approach to standard-setting has contributed to IFRS gaining increasing acceptance around the world. Surprisingly, however, there is currently little agreement on what principles-based standards are in practice or how standards-setters should aim to deliver them.

Given the anticipated extent of changes in IFRS in the coming years, the CEOs of the largest international audit networks (including Grant Thornton International) have published a White Paper "Principles-Based Accounting Standards". The White Paper aims to move the debate forward by suggesting a framework to use in developing principles-based standards. The Paper also recognises that cultural and behavioural changes will need to be made by other participants in the financial reporting process if a principles-based model is to succeed.

The White Paper proposes that principles-based accounting standards should:

1. Give a faithful presentation of economic reality
2. Be responsive to users' needs for clarity and transparency
3. Be consistent with a clear Conceptual Framework
4. Be based on an appropriately-defined scope that addresses a broad area of accounting
5. Be written in clear, concise and plain language
6. Allow for the use of reasonable judgment

The Discussion Paper can be downloaded at: **http://www.globalpublicpolicysymposium.com/GPPC_PBS_White_Paper.pdf**



Open for comment

This table lists the documents that the IASB currently has out for comment and the comment deadline. Grant Thornton International aims to respond to each of these publications.

Current IASB documents

Document type	Title	Comment deadline
IFRIC Draft Interpretation	D24 Customer Contributions	25 April 2008
IFRIC Draft Interpretation	D23 Distributions of Non-cash Assets to Owners	25 April 2008
IASB Discussion Paper	Discussion Paper: Financial Instruments with Characteristics of Equity	5 September 2008
IASB Discussion Paper	Reducing Complexity in Reporting Financial Instruments	19 September 2008
IASB Discussion Paper	Preliminary Views on Amendments to IAS 19 Employee Benefits	26 September 2008

Effective dates of new standards and IFRIC interpretations

The table below lists new IFRS Standards and IFRIC Interpretations with an effective date on or later than 1 January 2007. Companies are required to make certain disclosures in respect of new Standards and Interpretations under IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

New IFRS Standards and IFRIC Interpretations with an effective date on or later than 1 January 2007

Title	Full title of Standard or Interpretation or Interpretation	Effective for accounting periods beginning on or after	Early adoption permitted?
IAS 1	Amendment to IAS 1 Presentation of Financial Statements: Capital Disclosures	1 Jan 2007	Yes
IFRS 7	Financial Instruments: Disclosure	1 Jan 2007	Yes
IFRIC 11	IFRIC 11 IFRS 2 – Group and Treasury Share Transactions	1 March 2007	Yes
IFRIC 14	IAS 19 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction	1 Jan 2008	Yes
IFRIC 12	Service Concession Arrangements	1 Jan 2008	Yes
IFRIC 13	Customer Loyalty Programmes	1 July 2008	Yes
IFRS 8	Operating Segments	1 Jan 2009	Yes
IAS 23	Borrowing Costs	1 Jan 2009	Yes
IAS 1	Presentation of Financial Statements	1 Jan 2009	Yes
IFRS 2	Amendment to IFRS 2 Share-based Payment: Vesting Conditions and Cancellations	1 Jan 2009	Yes
IAS 32 and IAS 1	Amendments to Financial Instruments: Presentation and IAS 1 Presentation of Financial Statements: Puttable Financial Instruments and Obligations Arising on Liquidation	1 Jan 2009	Yes (but must be applied in conjunction with related amendments to IAS 39, IFRS 7 and IFRIC 2)
IFRS 3	Business Combinations (Revised 2008)	1 July 2009	Yes (but only for periods beginning on or after 30 June 2007 and must be applied in conjunction with IAS 27 Revised 2008)
IAS 27	Consolidated and Separate Financial Statements	1 July 2009	Yes (but must be applied in conjunction with IFRS 3 Revised 2008)