IFRS news

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Presenting financial performance – change on the horizon?

Regulators and standard-setters are thinking hard about alternative performance measures and further guidance via standard setting or regulation may not be comfortable for the preparer community. Peter Hogarth, a partner in PwC's Accounting Consulting Services, looks at recent developments.

The presentation of financial performance can be a battlefield where preparers of financial statements charge in to meet the regulators and standard-setters. Preparers, understandably, want to tell their story with a natural tendency to highlight the positive and pass quickly over any failures.

Regulators worry that the reader might be misled. Some regulators have responded by taking a hard line and imposing a standard format for the income statement with no additional sub-totals or analysis - a sort of uniform score card.

Elsewhere, creativity has flourished. Companies use columns, boxes, sub-totals and typeface to focus attention on 'underlying' or 'sustainable' earnings. This approach, the use of 'non-GAAP' measures, has its merits, but is not without its critics beyond the regulatory community.

How do the parties line up?

The standard setter

Hans Hoogervorst, IASB Chairman, said in a recent speech 'no single line can capture everything about a company's performance that a user will need'[1]. He was weighing in on the other comprehensive income versus net income debate.

The IASB is working on a broader project on disclosure. The tip of the iceberg will appear soon as an exposure draft on the first stage: narrow scope amendments on materiality, disaggregation of line items and order of notes. Much more will follow from the IASB on this topic.

Meanwhile, the European Securities and Markets Authority (ESMA) went to the IFRS IC with a question on non-GAAP measures. The IC did not enter the fray, declining the agenda request and booting the entire subject to the IASB. The IC did observe that IAS 1 not only permits flexibility in presentation but actually requires entities to present additional line items, headings and subtotals when relevant to an understanding of financial performance.

The regulators

ESMA has gone for a multi-pronged approach; publishing draft guidelines for listed companies that build on earlier recommendations from ESMA's predecessor body.

The UK's Financial Reporting Council ('FRC') is looking for merits on both sides of the debate. It recently reminded

[1] 05 February 2014 Hans Hoogervorst, Chairman of the IASB, *'Defining Profit or Loss and OCI... can it be done?'* speech to Accounting Standards Board of Japan

management of the need to improve the reporting of alternative performance measures and ensure consistency in their presentation. The FRC is not opposed in principle to non-GAAP measures but expects them to provide users with additional useful, relevant information. Recent enforcement actions have challenged the 'balance' of alternative measures as well as the consistency and clarity of disclosures around one-off or 'exceptional' items.

The Australian Securities & Investments Commission, however, has lined up for the uniform score card, making it clear that non-GAAP measures belong outside the financial statements altogether unless required by IFRS.

And everyone else?

Others have been weighing in. Few investors surveyed by PwC said they would ban non-GAAP measures but they would like some ground rules[2].

A Standard & Poor's study highlighted that adjusted profit measures may often give investors a 'misleading impression of performance'[3]. Adjusted profit measures are seen to outnumber the unadjusted measures. S&P also commented on the frequently seen 'recurring' non-recurring charges. The International Federation of Accountants has just issued a consultation on the same topic.

What is next?

Non-GAAP measures are high on the agenda of regulators and standard setters. Users want to paint a picture of sustainable earnings, but will continue to question the preparation and balance of these measures. Will we see dramatic changes in current practice? The only 'highly probable' outcome is that the debate will rage on.

IFRS 3: Relevance versus complexity – a difficult balance

Olivier Schérer, PwC IFRS Technical leader in France, gives his view on the issues under discussion by the IASB as part of its Post-implementation review of IFRS3 Business Combinations.

The IASB initiated a review of IFRS 3 based on how it has been applied in practice since implementation in 2010. The IASB has already identified 18 themes of concerns and is now asking for views from the IFRS community. I would like to comment on some of the issues.

Purchase of assets or business combination: the right question?

Many preparers have identified the difficulties in making this distinction. There is a perception that the guidance provided by IFRS 3 is not sufficient in some circumstances. But should it matter?

The distinction would not make a difference if the accounting principles for a purchase of assets and for a business combination were the same. But they are not. Some of the key differences relate to the recognition of goodwill, deferred taxes and acquisition-related costs. Looking at a recent example in the pharma industry, I would add to the list the accounting for contingent consideration, which, in this case, was the primary component of the purchase price.

Making the distinction matters when the impact of the accounting differences is

[2] December 2007, *Performance statement - Coming together to shape the future*

[3] 18 February 2014, Standard and Poor's *Ratings Direct - Why Inconsistent Reporting Of Exceptional Items Can Cloud Underlying Profitability At Nonfinancial FTSE 100 Companies*

material. But what is the real objective of the debate: is it to provide more guidance to facilitate the distinction, or is it to align the accounting?

I am concerned that providing more guidance will not address the real issue and will be an ongoing source of structuring opportunities. Aligning the accounting for purchase of assets and business combinations seems a more sensible approach. It would be an opportunity to reopen the debate around deferred taxes, so often misunderstood by the financial analysts, and to close the discussions relating to contingent consideration for separately acquired tangible and intangible assets.

Intangible assets and goodwill: does the complexity serve the relevance?

Many concerns are raised relating to:

- the recognition of intangible assets versus goodwill;
- the impairment test of goodwill versus amortisation; and
- the full goodwill versus partial goodwill approach.

Intangible assets versus goodwill

Recognising intangible assets separately from goodwill is perceived as a 'compliance exercise' but does not reflect the approach taken by management when valuing the business as whole. Besides, the IASB has noted that the value attributed to those intangible assets is "strongly influenced by the accounting result that management seek"[4].

Impairment of goodwill versus amortisation

IFRS currently does not allow amortisation of goodwill but requires an annual impairment test. We have all observed the complexity and judgments necessary for an impairment test, including the identification of the level at which goodwill is tested, the assessment of cash flows and its underlying assumptions. But there is also the assessment of whether internal reorganisations have sufficient substance to justify a reallocation of goodwill and the justification of sometimes significant differences between a fair value and value in use.

Mixed views are expressed on the amortisation approach and might also vary with the economic environment. Some of the merits of the amortisation of goodwill are (1) the lesser degree of complexity and subjectivity and (2) maybe a more accurate and relevant way to measure the return on capital employed.

Full goodwill versus partial goodwill

IFRS 3 allows a choice between recognising full goodwill (measured on a 100% basis like all other assets and liabilities) or partial goodwill (measured only for the portion acquired). This is different from US GAAP where only the full goodwill approach is accepted. The partial goodwill approach has merits because it does not artificially gross up the balance sheet. That said, it also creates many practical issues, especially relating to impairment tests after a change in parent's ownership interest.

These issues can hardly be addressed in isolation. One approach would be to eliminate the option for the partial goodwill approach, eliminate the requirement to recognise intangible assets separately from goodwill and require the amortisation of goodwill.

This practical approach would eliminate many of the complexities, increasing the consistency among IFRS preparers and the relevance of the income statement. It would also reduce opportunities for 'earnings management'. But this would be a departure from the recognition principles of intangible assets as per IAS 38.

Contingent consideration versus compensation expense: what does the expense reflect?

Many transactions include contingent payments to be paid to employees and/or former shareholders. IFRS 3 considers as a

[4] November 2013 IASB Meeting, Agenda paper 13A, IFRS 3 Business Combinations— Input obtained from Phase I of the PiR

non-rebuttable presumption that payments contingent upon the employees remaining employed for a certain period of time are compensation expenses. This would include circumstances when such an amount appears disproportionate compared to the services rendered. This results in a portion of the purchase price, sometimes significant, to be expensed. The effects are that the consideration does not reflect the real cost of the transaction which then impairs the ability to measure the return on investment.

I believe such guidance should be turned into a rebuttable presumption which would allow, in some circumstances, both the contingent consideration and the compensation expense to be recognised separately at fair value. This would allow each component to be accounted for in a way that reflects its economic substance.

"As if" accounting: the disconnect between cash and the P&L?

IFRS3 has also introduced some counter-intuitive accounting for step acquisitions, loss of control and other changes in interest, for example:

- step acquisitions (40% to 100% ownership): P&L impact for the fair value step up of the 40%, *as if* it had been sold
- partial disposal without loss of control (100% to 80%): No P&L impact, *as if* it was as transaction with shareholders
- loss of control (80% to 30%): P&L impact *as if* 80% had been sold, without 'recycling' through P&L the 20% previously sold.

No doubt there is some conceptual basis for this accounting, but does it really provide relevant information to the users and preparers as a measure of performance? When I hear financial analysts saying that they ignore those impacts, I have my answer.

Let's be positive: the IASB has identified the issues well. But let's also be realistic: some are more complex than others to address as the 'wish list' touches some of the fundamental concepts of IFRS 3 and other Standards. This will be for the IASB a delicate navigation where the ultimate objective should be relevance and simplicity.

This article represents the individual view of the author.

Debt or equity – regulatory reform adds fuel to the age old debate

Have you been following the saga on financial instruments with 'non-viability' clauses? If you answered no, don't worry; we are still in the early chapters and the story continues to unfold.

The story started with regulators looking to strengthen the capital base of financial institutions in response to the financial crisis. For example, the European Banking Authority (EBA) set new regulatory capital requirements where a bank must be capitalised to a certain threshold. If these minimum capital requirements are breached and the bank suffers severe financial distress, a wider range of the bank's investors and lenders should 'absorb the loss'.

What is a non-viability instrument?

A common way financial institutions are complying with these new capital requirements is to cancel or forgive the instrument, or to issue instruments that convert into a variable number of the entity's own ordinary shares when the minimum regulatory capital requirement is breached. This type of contingent feature is referred to as a 'non-viability' clause. Such clauses give rise to complex accounting questions for both the investor and issuer.

[4] November 2013 IASB Meeting, Agenda paper 13A, IFRS 3 Business Combinations— Input obtained from Phase I of the PiR

The IC has been following the story. They specifically discussed such an instrument at in January. The instrument converts into a variable number of shares when the issuer breaches its capital ratio (that is, the non-viability event described above). Otherwise, the instrument has no stated maturity and pays dividends at the issuer's discretion. When the IC first discussed the issue, they viewed the instrument as a liability to settle in a variable number of shares with an equity component for the discretionary dividends. However, questions arose about the whether the timing of the contigency should be considered and how the discretionary dividends should be classified. The IC received feedback on their draft agenda decision discussed in January.

The result of the January meeting was a decision that the issue was too broad for the Committee, which means that diversity in practice will probably continue.

The debt-equity debate continues

The questions surrounding non-viabiity instruments are just an extension of the age old debate about debt versus equity. The IC also looked at two other issues related to IAS 32 in their January meeting. One of these instruments focused on whether a particular contractual term is substantive and how this impacts the accounting classification under IAS 32. This decision raises questions about whether current practice will change in evaluating substance under IAS 32 going forward.

The IASB Discussion Paper on the Conceptual Framework started to touch on the issue but an easy solution is not likely. There is also an ongoing research project which will focus on financial instruments that are difficult to classify under the current requirements, or for which many question the classification.

See what John Hitchins, PwC Global Chief Accountant, thinks about the 'non-viability saga' in his blog.

Convergence on insurance contracts disappears over the horizon

International insurers hoping for convergence will have to wait as IASB and FASB move in different directions.

Many international insurers were still hoping for convergence to minimise differences in reporting between the US and the rest of the world. But the FASB recently decided to only make targeted changes to US GAAP, mainly for long-duration contracts in the life insurance industry. This means that convergence is not on the cards, at least in the near term.

Convergence has many benefits, but it also has the risk of delays as more parties are involved in decision making. At the same time, there continues to be an urgent need for a comprehensive insurance contract standard under IFRS. On the other hand, many users and preparers in the US did not see a need for change in accounting for insurance contracts and as such, the FASB moved in a different direction.

In addition, the IASB decided that the financial instruments standard, for which convergence already seemed far away, should be effective from 2018 (see Cannon Street Press). Users, preparers and auditors were concerned that insurers would have to go through a significant transition twice in a short timeframe.

Moving the effective date makes a combined transition to the insurance contracts and financial instruments standards more likely. The IASB will continue their discussions on the insurance contracts project in March and it has a significant stimulus to get the insurance contracts project done and who knows... 21 years after the project started, we may have an insurance contracts standard effective in 2018.

Cannon Street Press

IASB work plan update

IFRS 9 approved for ballot

The IASB decided the effective date of for both projects will be annual periods beginning on or after 1 January 2018 and granted permission to ballot both projects.

New revenue standard delayed

Publication of the new revenue standard has been delayed until at least the second quarter of 2014. The much anticipated new standard is the result of a joint effort between the IASB and FASB. No further board deliberations are expected.

IASB work plan as of 25 February 2014

The current IASB work plan as at 25 February 2014 is summarised below. This reflects the next major milestone for the some of the significant projects. There are a number of new standards expected.

The number of narrow scope amendments and research projects also on the agenda continues to grow. The most noteworthy include IAS 1 narrow scope amendments, unit of account for fair value measurements, separate financial statements, and various issues related to joint arrangements.

Project	Milestone	Expected date of issue per IASB Work plan
IFRS 9 – Classification and measurement (limited amendments)	IFRS	Q2 2014
IFRS 9 – Impairment	IFRS	Q2 2014
Accounting for macro hedging	Discussion paper	Q1 2014
Revenue recognition	IFRS	Q2 2014
Leases	Redeliberations	Ongoing
Insurance	Redeliberations	Ongoing
Rate regulated activities	Discussion paper	Q2 2014
IFRS 9 – Classification and measurement (limited amendments)	IFRS	Q2 2014

IC drops discussion of 'higher-of' plans

The IC has abandoned efforts to address the accounting for 'higher of' employee benefit plans, for example, plans with guaranteed minimum return. They cited an inability to reach consensus on a scope which would improve accounting without creating unintended consequences. The IC acknowledged existing diversity in practice and suggested that the IASB might address these issues through a broader consideration of employee benefits accounting.

Know your IFRS ‘ABC’: N is for ‘Non-controlling interests’

Mark Bellantoni from PwC’s Accounting Consulting Services Central goes back to basics on non-controlling interests.

Let’s take a common scenario – one entity buys or sells the shares of another entity. What accounting considerations first came to mind? You probably thought about some of the following questions:

- is a financial instrument settled or created, maybe convertible debt?
- what level of control is obtained or relinquished? Is there an associate, joint arrangement or subsidiary?
- should a gain or loss be recognised?

These are just the starting points.

But did you think about a parent’s purchase of shares held by the non-controlling interest (NCI) of its subsidiary?

This question is for many probably one of the last things to come to mind. NCI transactions seem to get very little press and minimal emphasis in the financial statements, despite their frequency. This article is a ‘refresher’ on some of the key points related to transactions with NCI.

The basics

Control is maintained

A parent’s purchase or sale of a partial ownership interest in a subsidiary is accounted for as an equity transaction when control is maintained. That is, the parent recognises no gain or loss in the income statement upon selling the subsidiary’s shares. Similarly, the parent will not record any additional goodwill to reflect subsequent purchases of additional shares in a subsidiary.

Instead, the carrying value of the NCI will be adjusted to reflect the change in the NCI’s ownership interest in the subsidiary. Any difference between the amount by which the NCI is adjusted and the fair value of the consideration paid (or received) is recognised in equity and attributed to the parent’s equity holders.

Transaction costs

How are transactions costs arising on NCI transactions accounted for? These costs are not part of the income and expense of the entity. They should be treated as a deduction from equity.

Share-based payments

Changes in a parent’s ownership interest in a subsidiary can also arise as a result of a share-based payment. The parent may grant some of its shares in its subsidiary to the employees of that subsidiary. These grants of shares (or eventual exercise of similar options) will dilute the parent’s interest in the subsidiary.

Grants of shares, options or other equity interest in a subsidiary must be evaluated carefully. Many of these transactions fall within the scope of IFRS 2 as they are exchanging some form of interest in the subsidiary for a good or service received. The parent is transacting with the employee in his/her capacity as an employee rather than in his/her capacity as an owner.

Post-business combination transactions

NCI is recorded at fair value (or proportionate share if chosen) only at the date of the business combination. Subsequent purchases or sales of ownership interests when control is maintained are recorded at the NCI’s proportionate share of the net assets.

A subsidiary may also issue additional shares to a third party, thereby diluting the controlling interest’s ownership. If this does not result in a change in control, it is accounted for as an equity transaction.

Examples

Let's look at a few examples.

Example 1 – Sale of a 20% interest in a wholly-owned subsidiary

Entity A sells a 20% interest in a wholly-owned subsidiary to outside investors for C200 million in cash. Entity A still maintains an 80% controlling interest in the subsidiary. The carrying value of the subsidiary's net assets is C600 million, including goodwill of C130 million from the subsidiary's initial acquisition.

The accounting entry recorded on the disposition date for the 20% interest sold is as follows:

Dr.	Cash	C200
Cr.	NCI (20% × C600m)	C120
Cr.	Equity	C80

The carrying value of the 20% non-controlling interest that is recognised is calculated as the proportionate interest in the subsidiary's carrying value/net assets.

Example 2 – Acquisition of a 20% interest in a subsidiary

Entity A acquired 60% of entity B some years ago for C3,000. At the time entity B's fair value was C5,000. It had net assets with a fair value of C3,000 (which for the purposes of this example was the same as book value). Goodwill of C1,200 was recorded (being C3,000 – (60% × C3,000)). On 1 July 20X5, entity A acquires a further 20% interest in entity B, taking its holding to 80%. At that time the fair value of entity B is C10,000 and entity A pays C2,000 for the 20% interest. At the time of the purchase the fair value of entity B's net assets is C6,000 and the carrying amount of the non-controlling interest is C2,000.

The accounting entry recorded for the purchase of the non-controlling interest is as follows:

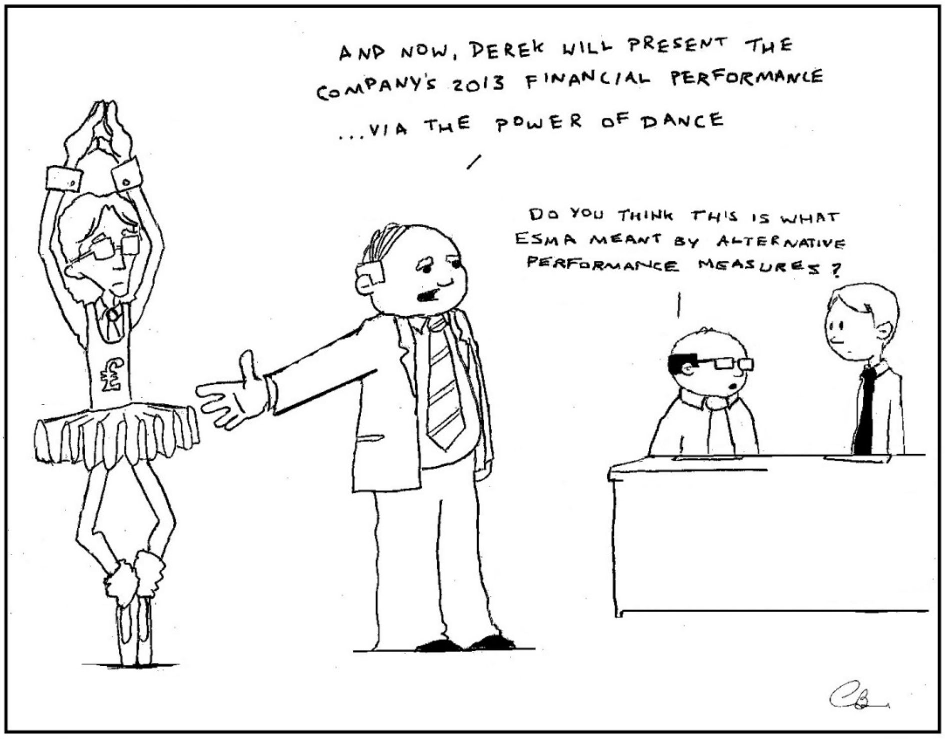
Dr.	Non-controlling interest	C1,000
Dr.	Equity	C1,000
Cr.	Cash	C2,000

The carrying value of the 20% non-controlling interest that is eliminated is calculated at the proportionate interest in the non-controlling interest's carrying value.

Control is the key

None of the transactions above resulted in a change in control. The assessment of control should not be overlooked, as transactions with NCI may trigger rights of option holders or other interest holders. If these other features are considered substantive after the transaction, the control assessment may need to be revisited.

The bit at the back.....



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