

RSM! Reporting

Welcome to the first edition of RSM Reporting - the electronic newsletter from RSM International covering technical developments in global accounting and reporting.

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Section 3: Top Ten Topics in IFRS

by *Stefano Bianchi*

Welcome from the Editor

Marco Mongiello

The current economic climate presents challenges to all. I make no exception. Identifying the most topical matters in international reporting in these days of high-paced developments and excited debates, is much greater a challenge than it would have been a year ago. I am, nevertheless, delighted to be editing this new publication: *RSM Reporting*. In order to bring you the cutting-edge of international reporting news and comments, the content is structured around 'Updates and News', 'The point of view of...' and 'Comments'. The first section will report bare facts about what's new and particularly what's forthcoming in the developments of accounting. In the second section, RSM experts will share their points of view on the latest topics, contributing to current debates and proposing recommendations. In the comments you can expect further reflections of non-RSM experts, such as in this edition, from the world of academia. Finally, *RSM Reporting* proposes a TopTenTopics section, addressing what challenges have emerged in the most recent practice.

On this premise, almost inevitably, prominent space has been given to Fair Value. For some, Fair Value is considered one of the culprits of the current financial crisis, and an approach to reporting that hinders accounting at its very core, as it makes it less reliable and more subjective. For others, Fair Value is the forefront of the evolution of accounting; it contextualises reporting in the economic environment, following more closely the needs of fast moving decision makers for up-to-date information. In the academy, Fair Value has recently caused some previously unimaginable changes, whereby the departments of finance and accounting have to dialogue between them to a more intense extent, feeding each other in the quest for the most appropriate methods and approaches to asset and equity valuation. Marco Marcellan reports on this and shares with us his point of view and proposals, which are partly corroborated by Prof. Paul Klumpes's comment, who highlights some of the most important criticisms to Fair Value.

With definitely less presence in the mass media, but equally important, are the other topics in this edition: the debate on revenue recognition, on which Jane Meade reports explaining her point of view with relevant examples; the income tax discussion, which is going public these days and to which Simon Fisher adds his own valuable point of view, including interesting considerations on the possible implications of different scenarios.

Finally, the TopTenTopics section will present, in this edition, the challenges faced by different entities in carrying out their impairment test. Gifted with the ability to simplify a very complex matter, Stefano Bianchi takes us through a three-step critical evaluation of the implementation of IAS 36.

If you have any queries on the issues raised in this edition, please do not hesitate to contact the respective authors or me at your convenience; in fact, the more contributions to the debate, the more interesting the outcomes.

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Exposure draft on fair value measurement released

Marco Marcellan reports

Milestones

Objectives:

- > to establish a single source of guidance for all fair value measurements
- > to clarify the definition of fair value and related guidance
- > to enhance disclosures about fair value
- > increase convergence between IFRS and US GAAP

Current status:

- > Exposure draft published on 28 May 2009
- > Comment letters' deadline: 28 September 2009

What's next:

- > Estimated project completion in 2010

The IASB has released the long-awaited exposure draft regarding the fair value measurement project. The starting point in developing the exposure draft was the equivalent US standard, SFAS 157 Fair Value Measurements. The proposed definition of fair value is identical to the definition in SFAS 157 and the supporting guidance is largely consistent with US GAAP. However, some significant differences still remain.

The following is a brief summary of some of the key decisions exposed:

- > Definition of fair value: the IASB tentatively decided to define fair value as it is defined in SFAS 157.
- > Exit price: the IASB tentatively decided to characterise fair value as an "Exit Price" as it is intended in SFAS 157.
- > Transaction price and fair value at initial recognition: the IASB has tentatively decided that "Day one" differences are recognised in accordance with the existing criteria in IFRS and therefore there will be divergence from SFAS 157.
- > Reference market: IASB tentatively decided that for fair value measurement purposes transactions take place in the most

advantageous market - the market in which the reporting entity would normally enter into a transaction for the asset or liability is presumed to be the most advantageous market. SFAS 157 focuses on the principal market and in cases where there is no principal market the reference market is the most advantageous market. As a result, there is no full convergence.

- > Blockage factor: IASB has tentatively confirmed to exclude blockage factors from a fair value measurement at all levels of the fair value hierarchy. If this decision is confirmed, it will result in divergence from SFAS 157.
- > Illiquid markets: In April 2009 the FASB issued the FASB Staff Position No. FAS 157-4 - Determining Fair Value when the volume and level of activity for the asset or liability have significantly decreased and identifying transactions that are not orderly. IASB has decided to include the guidance from the FSP in the exposure draft.

More on this topic in Section 2 in this newsletter



Debate on revenue recognition steps up

Jane Meade reports

Milestones

Objectives:

- > provide a single, revenue recognition model applicable to a range of industries
- > develop a model based on changes in specific assets and liabilities to eliminate weaknesses and inconsistencies in existing concepts and standards
- > converge IFRS and US requirements

Current status:

- > Discussion paper published on 19 December 2008
- > Comment letters' closed on 19 June 2009

What's next:

- > Exposure draft publication expected early 2010

The European Financial Reporting Advisory Group (EFRAG) has issued its draft comment letter on the IASB's Discussion Paper (DP) Preliminary Views on Revenue Recognition in Contracts with Customers. The DP was issued jointly with the US FASB in December 2008 and outlines the Board's initial views and proposals for a future joint standard on revenue recognition, which would replace numerous existing IFRS and US GAAP pronouncements.

The underlying proposal in the DP is that revenue recognition should be based on accounting for a contract with a customer and recognising revenue only when the entity satisfies a performance obligation. EFRAG note that whilst they welcome the work being undertaken on this project, they have a fundamentally different view as to when revenue should be recognised. Their main concern is in regard to construction-type contracts and service contracts, for which the proposals in the DP could result in a significant change to existing practice, with revenue recognition occurring much later than under existing standards on some of these contracts. EFRAG's concern is that the information provided in financial statements prepared under the proposals would be less useful to users. The view expressed by EFRAG is that revenue should be a measure of activity carried out to fulfil a contract with a customer. This would mean that revenue would be recognised as the entity progresses towards fulfilling performance obligations, rather than just on fulfilment.

Apart from this fundamental concern, EFRAG note that they agree with much of what the DP proposes, including having a single, universal set of principles for revenue recognition, the proposed definition of a performance obligation and the proposals on the separation of performance obligations and the measurement proposals. They do note, however, that further guidance will be required to achieve consistency in application.

The effect of the proposals on revenue recognition for construction-type contracts and service contracts is likely to be the most significantly debated issue in the DP and is most likely to have the greatest effect on entities.

More on this topic in Section 2 in this newsletter



Exposure Draft on Income Tax is finally ready

Simon Fisher reports

Milestones

Objectives:

- > to clarify and improve IAS 12 *Income Taxes*
- > to reduce the differences between IAS 12 and the US standard, SFAS 109 *Accounting for Income Taxes, and related US GAAP*

Current status:

- > Exposure draft published on 31 March 2009
- > Comment letters' deadline: 31 July 2009

What's next:

- > New standard expected to be finalised in 2010

The long awaited Exposure Draft (ED) on Income Tax, to replace IAS 12, was finally released. It is part of the convergence project to align IFRS more closely with US GAAP, but the IAS Board have also taken the opportunity to clarify a number of areas in the old IAS 12.

Some of the more significant changes proposed in the ED are:

- > Initial recognition exception: the exception in IAS 12 would be eliminated. Instead, when there are no 'entity-specific' tax advantages, deferred tax arising on initial recognition would be recognised, but any difference between the consideration paid and the total of the acquired assets and liabilities (including the deferred tax) would be classified as an allowance or premium and recognised in the statement of comprehensive income. The Basis of Conclusions acknowledges that the net effect of this will often be the same as if the deferred tax had not been recognised in the first place.

- > Tax base: the problem of temporary differences on initial recognition will be largely eliminated, however, by the ED's proposal that the tax base of an asset should always be determined using the assumption that the carrying amount of the asset will be recovered by sale. Since it will be rare that a tax liability would arise if an asset was immediately sold at its cost price, it will be unusual for a temporary difference to arise on initial recognition.
- > Measurement of deferred tax assets: all deferred tax assets should be recognised, then reduced by a valuation allowance to the highest amount that is "more likely than not" to be realisable against future taxable profit. Again, the Basis of Conclusions acknowledges that this would have no effect on the net amount recognised under IAS 12.
- > Investments in subsidiaries: the exception in IAS 12 allowing non-recognition of deferred tax on temporary differences arising on various investments will be limited to investments in foreign subsidiaries, branches, and joint ventures only, in line with US GAAP.
- > Presentation: IAS 12 requires that changes in the measurement of deferred tax, such as a change in the applicable tax rate, should be allocated to, say, other comprehensive income if that is where the respective deferred tax was originally charged or credited. The ED suggests following the US GAAP approach, where such changes are recognised in the income statement with limited exceptions.

Comments on the Exposure Draft can be placed directly on the IASB's website, www.iasb.org.

More on this topic in section 2 in this newsletter

... Marco Marcellan on Fair Value Accounting

Fair value accounting: what investors want?

As John T. Smith (IASB Member) said recently:

*"[...] the financial crisis has changed the world. It has served as a wake-up call to policymakers, regulators and standard-setters. It has exposed critical weaknesses in business practices and financial regulation. It has challenged beliefs that we once held, rightly or wrongly, as axiomatic. We will ultimately be judged on how we respond to this crisis. The result must be a more robust system of financial regulation suitable for the reality of integrated capital markets"*¹

Business Valuation has invaded Accounting

"The analysis of information that focuses on [business] valuation is called valuation analysis, fundamental analysis, or [...] security analysis" and addresses the investors' primary concern of how much to pay for equity shares or debt.²

On the other hand "financial statements shall present fairly the financial position, financial performance and cash flows of an entity"³

Over the last few decades, because of the explosion of organized capital markets for equity securities the "hunger" of information driven by investors has started refocusing the main purpose of accounting from "book-keeping" to "value-information-providing".

Investors trade equities based on their perceived value. Value is a multifaceted and complex concept which is central to the functioning of markets. The need for information in order to help investors to assess value has, therefore, led to a more sophisticated financial reporting environment. Capturing information to help assess value has become a fundamental component of financial reporting.

The merge between business valuation and accountancy has changed the rules of the game. This new scenario, combined with the financial turmoil, has brought new significant challenges and will require a reassessment of financial reporting objectives as a whole. Fair value measurement certainly represents an emblematic icon of this new era.

From Historical cost to Fair Value

In simple terms, the historical cost approach considers assets and liabilities as the result of past operations, whilst the fair value approach sees assets and liabilities as the net present value of future "information" (primarily quantitative, but also qualitative). The fair value approach is by far the preferred approach of investors.

Usually fair value is determined using a discounted cash flow or other generally accepted business valuation model. In any case, the major purpose is to capture the net present value of the expected cash flow from an asset, a liability or a combination of both (a business). The past might be important, but only in terms of the information it can provide in order to "predict" the expected cash flows - history is only one of the parameters to be used to perform the overall expected cash flow analysis.

However, we should bear in mind that even under the historic cost convention most figures are estimated and very few items in the financial statements are considered certain.

Financial statements built on fair value

IFRS are predominantly designed to recognize and measure individual assets and liabilities. Even though certain standards are applied grouping asset and liabilities (i.e. impairment tests [see next section 3]) the focus remains undoubtedly on individual items.

As a result, fair value measurement, as with the vast majority of other IFRS measurement attributes, is predominantly focused on individual items.

If all assets and liabilities were individually measured at fair value, we might be tempted to conclude that accounts prepared on this basis would provide users with the fair value of an entity and in turn that the adjusted book value would coincide with the fair value of the entity as a whole.

It is evident that this assumption is not correct. The aggregation of the fair value of 10 individual assets/liabilities is not necessarily equal to the fair value of those assets/liabilities considered as a whole. There are other assets that are "institutionally" not recorded in the balance sheet (i.e. internally generated goodwill, internally generated brands, know-how, R&D, workforce, etc.).

That is why a balance sheet, even if entirely prepared on the basis of fair value, will never replace an enterprise valuation. As acknowledged by IAS 36, Impairment of Assets, "assets work together to generate cash flows".

In business valuation, the approach where the value of asset-based analysis of a business is equal to the sum of its parts is known as asset-based approach. Book values are adjusted to fair market value. However, using this valuation approach, significant intangible assets or contingent liabilities are generally impossible to determine apart from the company's overall enterprise value. For this reason, the asset-based approach is not the most probative method of determining the value of going business concerns.

What investors really want?

"There is no financial analyst who would not want to know the market value of individual assets and liabilities".⁴

Investors like fair value. Fair value is forward-looking (accounts prepared using historical cost are backwards looking). Investors like the idea of fair value because ultimately they want to come up with the value of a business (or an entity) and a fair value measurement approach definitely helps in reaching this target.

Investors use financial statements as a relevant source of information in order to build their own valuation models and try to estimate the value of an entity (or individual business - segments - of an entity).

In this respect, the Framework of IFRS is crystal clear: "The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions."

On the other hand, the Framework also points out that "however, financial statements do not provide all the information that users may need to make economic decisions since they largely portray the financial effects of past events and do not necessarily provide non-financial information."

In other words, this means that, as illustrated before, even accounts prepared on a full fair value for individual assets/liability basis, would not meet the ultimate goal of investors to determine the fair value of an entity.

An innovative proposal

Considering that:

- 1) Fair value measurement is in principle a useful concept, but
- 2) The current use of fair value has some limitations,

why not add another statement to an IFRS set of financial statements, e.g. an enterprise value statement based on a detailed Discounted Cash Flow (DCF) model, and give investors directly what they are looking for?

If detailed enough and properly disclosed a DCF model would give investors all the information they need and would allow them to do sensitivity analysis and modify assumptions according to their expectations. That, we believe, would represent real financial transparency, particularly now, during the financial crisis.

Overall, fair market value still seems to be the favorite measurement convention - or at least the less imperfect. By adding an enterprise valuation based on management reasonable and supportable expectation we would:

- > Help management to explain the value they believe is in the entity, and
- > Investors would have the possibility to compare this to fair market value and adjust the management assumptions based on their own expectations.

Also, reporting the fair value in the additional statement and the traditional book value in the balance sheet would additionally emphasize that the "ultimate number" does not exist.

The balance sheet would still be anchored to the less subjective fair value measurement approach based on the market participant view. Whilst the additional statement would represent the point of contact between accounting and business valuation.

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¹ Source: IASB Website

² Source: S.H. Penman, Financial statement analysis and security valuation, 3rd ed., McGraw-Hill, 2007

³ IAS 1 para 13

⁴ A Comprehensive Business Reporting Model: Financial Reporting for Investors CFA Institute Centre for Financial Market Integrity, July 2007

⁵ G. Benston, 2006. Fair value reporting at Enron. Journal of Accounting and Public Policy, Vol. 25.

⁶ For further discussion of the problems in applying fair value reporting principles to insurance firms, see P. Klumpes, C. O'Brien and A. Reibel, 2009. International diversity in life insurance reporting: fair or unfair? Geneva Papers on Risk and Insurance.

⁷ R.A. Rayman, 2006. Accounting Standards: True or False? Routledge: London.

⁸ P. Klumpes, A. Reibel and P. Welch, 2009. Cash flow reporting by banks. Journal of Financial Transformation, (forthcoming).

Prof. Paul Klumpes - Comments on Fair Value

Fair value is a relatively important concept in identifying the valuation exposure of various complex financial instruments and is potentially more value relevant to market participants than historical cost in revealing the valuation of portfolios of firm assets and liabilities under current market conditions. However a fundamental criticism of fair value relates to its application to the aggregate of firm liabilities and assets of the reporting entity. This is because the entire valuation balance sheet of the firm is comprised of both tangible, intangible and relatively hard to measure portfolios of investments, property, inventory as well as of liabilities that comprise accrued obligations, loans, provisions and contingent claims related to pensions and other long term obligations. Moreover the major problem with fair value relates to the dual purpose of financial reporting. In other words while fair value is potentially usefully in assessing the efficiency and performance of a set of firms, it is limited because the extent of transparency and comparability is restricted to the relatively transparent portfolios of assets and liabilities to which its value relates.

The first criticism is that in many situations fair value techniques require the development of subjective and in some cases questionable assumptions which are not easily validated and can lead to managers misleading investors. Such a situation arose at Enron, where managers misled shareholders about the value of complex and hard to measure transactions relating to the new market that they had created.⁵ Second, in many contexts, fair value is not an appropriate basis for financial reporting. For example, pension funds, banks and insurance companies manage portfolios of liabilities which are not easily matched to assets and therefore it is difficult to develop a replicating portfolio that is easily amenable to valuation. In particular, insurance companies manage portfolios of long term, contingent event payable insurance policies for which a readily exchangeable and deep and liquid market is not easily available.⁶ They have developed market consistent valuation methodologies which are still not easily reconcilable with accepted accounting practices in other contexts. A third criticism of fair value is that, since it does not apply to the valuation of shareholders equity, it is not possible to develop a 'perfect' fair value balance sheet. Moreover, the development of hybrid securities and other financial innovations in capital raising has increased the ambiguity of the distinction between liability and equity. For example, many firms may be exposed to or create various types of loss absorbing capital, such as pension shortfalls, contingent capital, forms of preference capital etc, or insurance linked securities, which can neither be easily classified as liabilities or equity.

By contrast, if the fundamental objective of financial reporting is to provide information about stewardship on the safekeeping of resources, then fair value is of limited usefulness because the major purpose is to assess performance in relation to resources made available and allocated. Since the consumption of those resources requires a frame of reference in respect of what was allocated to the manager in the past, fair value by definition, by focusing on value in exchange between a willing buyer and seller, does not provide useful information for this purpose. Since stewardship reporting also requires that gains or losses can only be recognised upon realisation, then the fair value reporting system is incompatible with this stewardship reporting purpose. Moreover, a change in the fair value of a set of held portfolio of assets or liabilities over time cannot by definition be treated as income; yet recent new proposals of accounting standard setting bodies allocate these changes to performance.⁷ For example, many banks have recently recognised as profits the deterioration in the value of their loan obligations as a consequence of credit downgrades. However it is arguable whether changes in credit risk should be recognised in accounting at all. Arguably, banks have used and abused fair value to mislead investors about the fundamental volatility and lack of liquidity of their portfolios. An alternative basis for reporting is to rely on cash flow statements; these neither make assumptions about 'accruals' or permit changes in the underlying value of assets or liabilities to be recognised unless they have been sold.⁸

In conclusion, fair value as a measurement basis for financial reporting has provided an important breakthrough in identifying the transparency of complex financial instruments, such as derivatives and other forms of complex contingent claims, to which many firms are exposed in mitigating and transforming their market risks. However it suffers from serious deficiencies when it is also used as a basis for performance reporting, particularly where the purpose is to report stewardship of the use of resources over time and where portfolios of assets and liabilities are relatively opaque to measure. One proposal is to develop two separate forms of accountability; one using relatively conservative historical cost and 'value in use' reporting for stewardship, and another for current performance and valuation which is then subject to subsequent evaluation about the quality of management judgements by shareholders. It remains an issue for further educationalist, practitioners and researchers to further debate these issues.

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... Jane Meade on the discussion paper Preliminary Views on Revenue Recognition in Contracts with Customers

Whilst the International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) note in their joint discussion paper (DP) that revenue recognition would not change for many contracts with customers under the proposals, there are a number of key areas where significant changes are anticipated, many of which are creating debate among the Board and constituents.

The proposed principles for revenue recognition are based on accounting for a contract with a customer and the rights and obligations that flow from the contract, being the entity's right to payment from the customer and obligation to provide goods and / or services ("performance obligations"). The "net contract position" for the entity will arise from combining the rights and obligations under the contract and could be an asset, liability or nil position of the entity. Increases in the net contract position (which arise from reducing performance obligations) over the life of the contract give rise to revenue recognition. In this way, it can be seen that under the proposals, revenue will reflect the transfer of goods and / or services to a customer rather than activities of the entity in fulfilling the contract. For goods, transfer will usually take place when the customer takes physical possession of the goods. For services, however transfer will occur only when the customer has received the promised service.

This is where the main differences between the proposals and current practice arise and the main effect would be seen in revenue recognition on construction and other similar service contracts. Under IAS 11 Construction Contracts, revenue is currently recognised on a percentage of completion basis, whilst under the DP proposals, this would only be appropriate if the customer controls the asset as it is being constructed. In most construction contracts, the asset would not be controlled by the customer until practical completion of the contract which would result in revenue not being recognised until that point.

The DP proposals would also likely result in a change to the treatment of the costs of obtaining contracts, such as sales commissions. Currently, many entities capitalise such costs in accordance with IAS 11, and recognise them with contract revenue on a percentage of completion basis. The proposals do not include such guidance in a new revenue standard, hence costs will be expensed as incurred unless they are able to be capitalised under another standard. As this will generally not be the case, the costs will be expensed as incurred. As revenue recognition in such contracts will often be delayed, the result will often be a loss being recognised on inception of a contract.

Another key effect arising from the proposals is that contracts will often be comprised of a

number of performance obligations over time, and these obligations may be for both goods and services. When these will be delivered at different times over the life of the contract, it will be necessary under the proposals to "unbundle" the performance obligations and account for them separately. Currently there is little guidance provided in IFRS as to how to account for these so-called multiple-element arrangements.

An example of the application of the proposals, as provided in the DP, is warranty obligations, which are currently considered incidental to the sales contract and not recognised as a separate component of revenue. Rather the expected cost of the service delivery is recognised as an expense when the revenue is recognised. Under the proposals, warranty obligations which are not sold separately with goods will meet the definition of performance obligation and, as a result, revenue for this part of the contract will not be recognised until the services are delivered to the customer. This means that a portion of consideration received for the sale of a good, where there is a standard warranty attached to the good, will be deferred and recognised as revenue over the period of warranty. This will also include a margin component, which is not generally considered in measuring the obligation in current practice.

Under the proposals, the allocation of consideration should be based on stand-alone selling prices of the components of the contract. Where there is no observable stand-alone price for a performance obligation the price will have to be estimated. Similar principles will also apply to many software sales, other maintenance services, goods sold with a right of return and sales incentives. In respect of software sales, the current practice under USGAAP is that revenue from the sale of software and ongoing support are not required to be separated if there is not an observable price for the ongoing support services. The DP proposals would significantly change this treatment by requiring an estimate to be made.

In most cases, performance obligations will not need to be re-measured; however a clear exception in DP is onerous performance obligations. These will occur when the expected costs to satisfy the obligation exceed the carrying amount in the statement of financial position. On re-measurement of the performance obligation, a contract loss will be recognised. The Boards are still considering whether re-measurement is appropriate in situations other than when a contract is onerous.

It is our opinion that the proposals contained in the DP could have far-reaching consequences for many entities in terms of how their results will be affected.

Construction contract example

A contractor enters into a \$2 million dollar two-year contract to construct machinery for a customer. Estimated costs of this contract are \$1.1 million. The contractor measures stage of completion by completion of a physical proportion of the contract work. Assume at the end of year 1, 50% of the contract activity has been completed and the outcome of the contract can be estimated reliably. Under IAS 11 Construction Contracts, revenues and costs related to this contract would be recognised in proportion to the service undertaken, that is \$1 million and \$0.55 million respectively.

Under the proposals, if control of the asset does not transfer to the customer until physical completion, and no payment is received until that time, the only entry will be to record work in progress as the machinery is built, because the rights and obligations under the contract are equal until completion. If, however, the customer prepaid the consideration, there would be a contract liability (similar to current deferred revenue) as well as WIP for the term of the contract until the machine is completed. Either way, revenue will not be recognised until completion.

Our view is that in many instances the informational value contained in financial statements will improve under the proposals. However, we question whether this will be the case for construction contracts where the DP considers there is not continuous transfer of services because the constructed asset does not pass to the customer until it is completed. The DP proposal is that activities undertaken by an entity in fulfilling a contract only result in revenue recognition as those activities occur if they simultaneously transfer assets to the customer.

In many contracts for construction, this is not currently the situation. The guidance in the DP on this area is not clear as to the circumstances under which continuous transfer is considered to occur.

In addition, the DP does not allow re-measurement of, for example, warranties, and this may result in amounts other than the current best estimate being reflected which would, in turn decrease the decision-usefulness of the information.

It is anticipated that there will be much debate around the proposals in the future and, as we will be involved in the debate, we will keep entities up-to-date with its developments.

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Warranty example

A television manufacturer sells a television to a customer for \$4,000. All televisions are sold by this manufacturer with a standard two-year warranty. Under IAS 18 Revenue the manufacturer would recognise \$4,000 revenue at the point of sale. In respect of the warranty, IAS 37 requires the manufacturer to determine the best estimate of costs that will be required to make good under the warranty, based on past experience. The entry to recognise this would be debit expense, credit provision for the best estimate amount. At each reporting date, the best estimate would be revised as required.

Under the DP proposals, the manufacturer will be required to allocate the \$4,000 consideration to 2 separate obligations, being the sale of the television and the warranty obligations. This allocation will be based on the proportion of an estimate of the stand-alone sales prices of the television and warranty. Therefore, even though the warranty is not sold separately, the manufacturer will be required to estimate what the sales price would be if this were the case. Assume the manufacturer allocates the \$4,000 as \$3,500 for the television and \$500 for the warranty. Revenue of \$3,500 will be recognised at the point of sale and a contract liability of \$500 will also be recognised. This \$500 will be recognised as revenue continuously over the two-year warranty period.

... Simon Fisher on the Exposure Draft on Income Tax

The long awaited Exposure Draft (ED) on Income Tax, to replace IAS 12, was released, after a gestation period of some five years. It is part of the convergence project to align IFRS more closely with US GAAP, but the IAS Board have also taken the opportunity to clarify a number of areas in the old IAS 12. The exposure draft is certainly easier to read, and there is now a separate "Basis of Conclusions" that better explains the rationale behind some of the requirements of the Standard. Illustrative examples have also been provided in a separate document.

The ED starts with a clear statement of principle, which is to recognise liabilities or assets in respect of tax payable or recoverable in the future as a result of past transactions or events.

As with IAS 12, the ED dispenses fairly quickly with current tax and focuses mainly on deferred tax.

Initial recognition exception

One of the more significant changes proposed is the much proclaimed elimination of the "initial recognition exception". IAS 12 prohibits the recognition of a deferred tax asset or liability on a temporary difference that arose on initial recognition of an asset or liability when that asset or liability was not acquired as part of a business combination and the transaction did not affect accounting or taxable profit. The ED suggests that if there are no 'entity-specific' tax advantages, the deferred tax should be recognised on initial recognition, but that any difference between the consideration paid and the total of the acquired assets and liabilities (including the deferred tax) should be classified as an allowance or premium and recognised in the statement of comprehensive income. The

Basis of Conclusions acknowledges that the net effect of this will often be the same as if the deferred tax had not been recognised in the first place. Deferred tax should be recognised separately in respect of 'entity-specific' tax advantages.

We endorse this as a pragmatic and simple solution that should be acceptable to most companies.

Tax base

However, the problem of temporary differences on initial recognition will be largely eliminated by the ED's proposal that the tax base of an asset should always be determined using the assumption that the carrying amount of the asset will be recovered by sale. Since it will be rare that a tax liability would arise if an asset

was immediately sold at its cost price, it will be unusual for a temporary difference to arise on initial recognition.

In our view: the Basis of Conclusions does not attempt to argue this change on conceptual grounds, and it is another pragmatic solution which is expected to achieve a high degree of convergence with US GAAP. It responds to the oft-asked question: "But if I sell this asset I will not have to pay any tax, so why do I have to recognise a deferred tax liability?" If this change survives in the published standard it could result in significant reductions in deferred tax liabilities in some jurisdictions, particularly on revaluation surpluses on buildings that do not qualify for capital allowances for tax purposes. It is therefore likely to be a popular amendment.

Measurement of deferred tax assets

A seemingly superficial change relates to the recognition of a deferred tax asset. IAS 12 said that a deferred tax asset should be recognised only to the extent that it was probable that taxable profits would be made in the future against which the deductible temporary difference could be offset. The ED proposes that all deferred tax assets be recognised, then reduced by a valuation allowance to the highest amount that is "more likely than not" to be realisable against future taxable profit. Again, the Basis of Conclusions acknowledges that this would have no effect on the net amount recognised.

We believe that the suggested approach is more consistent with the approach taken for, say, financial assets - recognise, then adjust - and should be acceptable to most companies.

Investments in subsidiaries

At present IAS 12 allows the non-recognition of deferred tax on temporary differences arising on the carrying amount of investments in subsidiaries, branches, associates and interests in joint ventures when the entity can control the reversal of the temporary difference and it is probable that the temporary difference

will not reverse in the foreseeable future. The ED proposes that this exception be limited to investments in foreign subsidiaries, branches, and joint ventures only, in line with US GAAP.

It is our opinion that the Basis of Conclusions rightly argues that the exception in IAS 12 should be removed altogether, since the timing of reversals is not a factor that should be taken into account in determining whether to recognise a deferred tax asset or liability. However, the Board have agreed to converge with US GAAP in view of the possible complexity in determining the temporary difference for investments in foreign entities; another acceptable pragmatic compromise.

Tax on distributions

For entities that are subjected to additional income tax when profits are distributed, IAS 12 stipulated the use of the undistributed tax rate in measuring deferred tax. The ED suggests that the choice of rate should be based on past practices and expectations of future distributions.

We think that this proposal should be accepted - it is consistent with the concept of providing for the "best estimate" of the amount that will be paid (IAS 37).

Uncertain tax positions

IAS 12 was silent on how to deal with uncertainty relating to tax positions. The ED proposes that current and deferred tax assets and liabilities be measured at the probability-weighted average of all possible outcomes, assuming that the tax authority examines the amounts reported to it and has full knowledge of all the relevant information.

This is a theoretical approach which, we believe, will not be easy to apply in practice, since there will rarely be sufficient data available to enable a "probability-weighted average" to be estimated. Also, an issue will arise if a tax liability is estimated assuming "that the tax authority examines the amounts", but then the tax authority does not examine the amounts - what would be the criteria for derecognising

the liability in a subsequent period? A better approach would be to require that uncertain tax liabilities be recognised as best estimates, and that the major sources of estimation uncertainty be disclosed in accordance with IAS 1.

Presentation

Whereas IAS 12 requires that changes in the measurement of deferred tax, such as a change in the applicable tax rate, should be allocated to, say, other comprehensive income if that is where the respective deferred tax was originally charged or credited (referred to as 'backwards tracing'), the ED suggests following the US GAAP approach, where such changes are recognised in the income statement with limited exceptions. The ED includes an alternative approach that "the Board does not propose to adopt" that would require backwards tracing, if practicable.

However, in our experience backwards tracing is a more logical approach, and is quite practicable in many cases: for example, measuring the change in deferred tax in respect of the revaluation of property, plant and equipment. The alternative approach therefore seems more appropriate. We believe that prohibiting backwards tracing will result in unnecessary distortion of earnings per share in some cases.

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Stefano Bianchi selects challenging examples from practice

The challenges of preparing financial statements in accordance with IFRS vary from entity to entity, according to the industry where they operate, the country where they report and their own specific circumstances. However, not surprisingly, in our experience some challenges have proved to be common to most reporting entities cross-country and cross-industry. These are, in our view, the Top Ten most relevant Topics from the practice since 2005. In this and the next editions of RSM Reporting we will report some examples relevant to these topics and comment upon their practical implications:

1. Impairment
2. Fair Value measurement
3. Derecognition of financial instruments and Consolidation of Special Purpose Entities
4. Purchase Price Allocation and Intangible assets
5. Debt vs. Equity
6. Hedging
7. Deferred Tax
8. Revenue recognition
9. Employee benefits
10. First-time adoption of IFRS

In this issue: "Impairment: three steps, three challenges"

Impairment testing continues to represent one of the most controversial issues in the implementation of IFRS, often raising questions and sparking debate among preparers, auditors and, quite importantly, regulators. Impairment has also been in the news a great deal in the last few months. Behind many headlines that include the unfortunately common statement "...largest loss in their history" there will be mentioned an impairment (e.g.: "RBS' Q1-2009 profits are wiped out by €5.3bn impairment", "...of Rio Tinto's total post tax impairment charge of \$8.4bn for 2008, \$7.9bn relates to the group's aluminium businesses"....).

What follows is a three-step approach with commentary for the implementation of IAS 36. Each step is accompanied by examples, drawn from recent practice in Europe.

It is worth remembering, when considering these examples, the rationale of IAS 36. The objective of the impairment test is to review an asset's balance sheet carrying amount; if the carrying amount exceeds the higher of its "value in use" or its "fair value less costs to sell", the reporting entity will recognise an impairment loss for the difference (see table 1). As straightforward as the rationale might seem, most of the implementation problems arise from the determination of the Value in use.

Step 1. Determine the Cash Generating Units (CGUs)

The impairment test is applied to CGUs. A CGU is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or group of assets. The impairment test needs to be applied at CGU level after attributing the assets of the CGU. The structure of CGUs should be viewed as a strategic issue by entities assessing an acquisition target. Identifying the CGUs and their cash flows is a difficult task and often reporting entities tend to reduce them in order to avoid complex calculations.

For example, Rio Tinto, the Australian Group involved in metal and mining production, in its 2008 consolidated financial statements, discloses that "the groups of cash-generating units represent the lowest level within the Group at which goodwill is monitored for internal management purposes and these groups are not larger

than the reporting segments determined in accordance with IAS 14 'Segment Reporting'". Rio Tinto's CGUs that have incurred an impairment in 2008 are:

- Upstream Aluminium
- Downstream Aluminium
- Hlsmet
- Argyle Diamonds
- Palabora
- Tarong Cool Mine

Rio Tinto, 2008 Annual Report, page 17

5 IMPAIRMENT (CHARGES)/REVERSALS	Pre-tax 2008 US\$m	Taxation 2008 US\$m	Outside interests 2008 US\$m	Net amount 2008 US\$m	Net amount 2007 US\$m
Cash generating unit					
Upstream Aluminium (a)	(6,131)	4	-	(6,127)	-
Downstream Aluminium (excluding Packaging) (b)	(1,210)	230	-	(980)	-
Hismelt (c)	(254)	72	-	(182)	-
Argyle Diamonds	-	-	-	-	(328)
Palabora (e)	-	-	-	-	100
Tarong coal mine (f)	-	-	-	-	134
Other	(420)	132	13	(275)	(19)
	(8,015)	438	13	(7,564)	(113)

Another example is offered by Inditex, the Spanish fashion group which owns Zara and Massimo Dutti chain stores. It has defined each of the commercial premises in which it carries out its activities (stores) as basic cash generating units, although these basic units can be aggregated to chain-country level, or even to all the companies located in the same country.

As it can be seen from these two examples, the definition of CGU is challenging in that it requires some creativity, pragmatism and, above all, a profound knowledge of the business and the sector where the entity is operating. Only a combination of these skills will enable the creation of CGUs that are manageable, still reflecting the business 'fairly' and that are in line with the common best practice in the sector. As a result, many different definitions are possible, all equally justifiable, which can affect values and informational value of the entities' accounts.

Step 2. Estimation of future cash-flows

The carrying amount is calculated starting from a projection of cash flowing from the CGUs to the entity. Cash flow projections should be based on reasonable assumptions that represent the management's best estimate of the range of economic conditions that will exist over the remaining useful life of the asset. Management must assess the reasonableness of the assumptions used as the basis for the current cash flow projections and give greater weight to assumptions supported by external market data. The cash flow projections must be based on the most recent financial budgets that have been approved by management.

The most popular model used is the DCF - Discounted Cash Flows - with a 5-year period, however the model is often pushed to a longer period (e.g. 10 years). For example, Novartis, the Swiss pharmaceutical Group, in its 2008 financial statements indicates that "If no cash flow projections for the whole useful life of an intangible asset are available, we utilize cash flow projections for a five-year period based on management forecasts, with a terminal value based on sales projections usually in line or lower than inflation rates for later periods".

Novartis, Annual Report 2008, page. 199

Divisional segmentation of goodwill and intangible assets of continuing operations

The net book values at December 31, 2008 of goodwill and intangible assets are allocated to the Group's Divisions as summarised below:

	Goodwill	Acquired research & development	Core development technologies	Trademarks, product & marketing rights	Other intangible assets	Total of intangible assets other than goodwill
	US\$m	US\$m	US\$m	US\$m	US\$m	US\$m
Pharmaceuticals	2,739	1,666	6	1,841	165	3,678
Vaccines and diagnostics	1,111	525	205	1,442	177	2,849
Sandoz	6,852	186	342	1,952	40	2,520
Consumer Health	583	174	-	803	1	978
Corporate	-	-	-	-	9	9
Total	11,285	2,551	553	6,038	392	9,534
Potential impairment charge*				28		28
Potential impairment charge *				63		63

The challenge, here, is on the ability to predict the cash flows for such a long period of time. This might prove particularly difficult in certain sectors, where the business is permeated with uncertainty, more than in others. In the example shown above the achievement of the desired results from the compounds in production or still at research and development level, will dramatically affect the projected cash flows. The last two lines of the table reported above are a clear hint that a range of confidence exists in the valuation and a sensitivity analysis could be a sensible exercise to carry out, when considering these cash flows.

Step 3. Selection of the discount rate

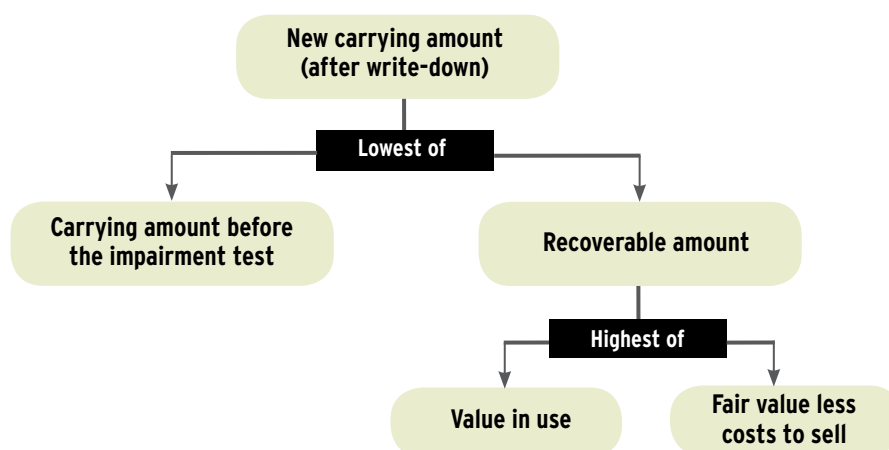
In measuring value in use, the discount rate used for the purpose of carrying out the DCF of the CGU should be the pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the asset. The discount rate should not reflect risks for which future cash flows have been adjusted and should equal the rate of return that investors would require if they were to choose an investment that would generate cash flows equivalent to those expected from the asset. There are numerous starting points for deriving the discount rate, such as the entity's incremental borrowing rate and the entity's cost of capital. Some of the businesses will be riskier than others; the discount rates should reflect that in its risk premium component. The assessment of risk is ever changing, as it is particularly evident in periods of financial turmoil like the current one.

The most commonly applied discount rate is based on the Group's weighted average cost of capital (WACC) which is considered in common market practice to be a good proxy for the capital cost of a market participant, and is adjusted for specific country and currency risks associated with the cash flow projections. A common way to avoid the calculation of a pre-tax discount rate (WACC is not pre-tax) is using cash flows, which also take into account tax expenses because the use of the post-tax discount rate approximates the results of using a pre-tax rate applied to pre-tax cash flows. This approach has been followed for example by GlaxoSmithKline, the UK pharmaceutical Group, which "as post-tax discount rate used the Group WACC of 8%, as most cash generating units have integrated operations across large parts of the Group. The discount rate is increased where specific country risks are sufficiently significant to have a material impact on the outcome of the impairment test. The Group WACC is equivalent to a pre-tax discount rate of approximately 11%."

The challenge, here, is to provide a justifiable discount rate, which encompasses as many variables as possible, to be representative of all entity's operations alike. The end result, though, is often what sounds like an almost axiomatic choice of a corporate rate. In this example the definition ends up in a tautology, i.e. the discount rate is increased where the risk is such that it will affect the impairment test, but the effect on the impairment test is conveyed by the increase in the rate itself!

Hence; three steps, three challenges, three more reasons for being very rigorous in the implementation of IAS.

Table 1: The Impairment model



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