

ROUNDTABLE

CONSISTENT APPLICATION OF IFRS

BRUSSELS, 18 OCTOBER 2007

ISSUES PAPER

NOTICE TO THE PUBLIC

This paper has been compiled using written contributions from individual participants to serve as a basis for the discussions at the meeting of 18 October 2007. Any opinions or recommendations expressed in these paragraphs are those of the proposer(s) concerned and not the views of the Roundtable or of the Commission.

No interpretations of IFRS should be inferred from the contents of this paper.

ROUNDTABLE

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ISSUES PAPER

A. Brief overview of issues proposed

ISSUE 1 – Regulatory Liabilities – follow up issue

Proposed by: FEE

Utility companies are often subject to price regulation by regulatory bodies and/or governments. Regulators set the level of financial parameters e.g. unit selling prices, total income or return, and reset the level periodically depending on the past performance of a company. As a consequence utility companies might have to pay back any additional surplus or might be able to cover any unplanned deficit incurred during the "control period" in the following period.

The issue has been raised as to whether utility companies, in expectation of a future increase or decrease of regulated prices, could or should recognise an asset/liability. The question is whether in cases of increases this would trigger recognition of an intangible asset (IAS 38), a financial asset (IAS 32) or accrued income (IAS 11/18). In cases of decreases of regulated prices the question is whether a provision (IAS 37), a financial liability (IAS 32) or deferred income (IAS 11/18) should be recognised.

The IFRIC has debated the issue of regulatory assets and argued that in order to be recognised they would need to meet the definition of assets. IFRIC concluded that recognition criteria of US literature are not fully compatible with the IFRS Framework. This paper focuses on regulatory liabilities.

ISSUE 2 – IAS 17 Leases – exercise of renewal/extension option – follow up issue
Proposed by: FEE

There are lease contracts that from the outset include renewal or extension options. If the exercise of such an option is considered unlikely at the inception of the lease it will not impact on the classification of the lease contract. The question is whether the actual exercise of a renewal or extension option during the lease period, which is not to be seen as a re-negotiation and therefore a change of the provisions of the lease contract, requires the (re-)assessment of the classification of the lease with respect to the renewal/extension period. Some believe that a reassessment of the exercise of an extension/renewal option might be inconsistent with IAS 17.13 (and/or IFRIC 4). The alternatives are either, not to reassess and so the classification for the remaining term of the original lease term and thus the extension period continues or, to treat the renewal period as a new lease contract.

ISSUE 3 - Waste of Electrical and Electronic Equipment (WEEE) – follow up issue
Proposed by: BUSINESSEUROPE

IFRIC issued IFRIC 6 providing guidance on accounting for WEEE based on the EU Directive 2002/96/EC. Whilst the EU Directive distinguishes between different categories of waste, IFRIC 6 only deals with historical waste from private households. For other categories, e.g. new waste, it is unclear whether to apply IFRIC 6 in analogy or IAS 37. National interpretations have been developed and therefore divergent accounting is expected to emerge in practice.

ISSUE 4 – Parent company guarantees over subsidiary pension scheme and other liabilities
Proposed by: FEE

It is common for a parent company to write a "guarantee" to a third party in respect of certain obligations of a subsidiary. One example that occurs frequently in practice is a parent guarantee of a subsidiary's pension obligations. The guarantee is that the parent will fund the scheme if the subsidiary fails to make the payments that it is required to in respect of the scheme's funding. The beneficiary of the guarantee is the pension scheme. In jurisdictions where sponsoring employers are required to make risk-adjusted contributions to a pension protection scheme, the guarantee can reduce the required contribution rate. This paper considers various possible views of how such guarantees should be classified and accounted for under IFRS in the parent's separate financial statements. This paper focuses on pension guarantees, although similar issues arise in respect of parent guarantees of a subsidiary's operating lease rentals, debt facilities or tax obligations.

ISSUE 5 – IAS 8/IFRS 3 – Business combinations involving entities under common control that are accounted for using the pooling of interest method – comparative figures

Proposed by: FEE

One method of accounting for business combinations under common control is the pooling of interest method. It has to be applied via the hierarchy in IAS 8, because IFRS 3 does not address this issue. It appears that there are divergent views on whether comparative figures need to be adjusted in the case that the pooling of interest method has been applied to transactions involving entities under common control.

ISSUE 6 – IAS 28/IFRS 3 – Purchase accounting for acquiree's interests in associates in a business combination

Proposed by: unanimous

There are cases of business combinations where the acquiree holds interests in associates accounted for by the equity method. It seems to be unclear whether the acquiree's interest in associates should be recognised at the acquiree's share of the full fair value of the interests in associates or the share of the fair value of the identifiable assets, liabilities and contingent liabilities in the associates.

ISSUE 7 – IAS 19 Employee Benefits – Application of the classification of compulsory industry-wide multi-employer pension schemes in the Netherlands

Proposed by: Dutch ASB

With the adoption of IFRS in 2005, a significant debate ensued in the Netherlands on the classification of compulsory industry-wide multi-employer pension schemes under IAS 19.25-27 as either defined contribution (DC) plans or defined benefit (DB) plans, when under previous GAAP these were accounted for as DC. This debate is still ongoing. For that reason both the Royal Dutch Institute of Chartered Accountants (Koninklijk NIVRA) and the Confederation of Netherlands Industry and Employers (VNO-NCW) requested the Dutch Accounting Standards Board (DASB) to raise this issue with the EU Roundtable for the purpose of determining whether this issue should be put before IFRIC for resolution.

B. Detailed description of issues proposed

ISSUE 1

Regulatory liabilities in certain regulated industry sectors

Proposed by: FEE

Background

In many countries, private sector utility companies are regulated, in the public interest, to ensure that their pricing provides an appropriate and fair balance between the interests of shareholders and customers. Generally, prices would be set based on agreed budgets for costs and revenues for the next period, and profit shortfalls and surpluses in one period would be recovered through price adjustments in future periods or other contractual mechanisms.

Under some accounting frameworks, such entities are permitted or required to defer losses, or excess costs, as ‘regulatory assets’ that will be recovered through future price increases. Similarly, they may be permitted or required under some accounting frameworks to defer excess profits as ‘regulatory liabilities’ for amounts that will be returned to customers through decreases in tariffs in future years.

Such an approach to regulatory assets and liabilities is applied, for example, under US GAAP in FAS 71, Accounting for the Effects of Certain Types of Regulation.

IFRS do not provide specific guidance on regulatory assets/liabilities and in particular on recovery/return of costs/cost reductions through future increases/decreases in regulated tariffs. and therefore the question arises as to whether, under the GAAP hierarchy in IAS 8, the guidance under FAS 71 for regulatory assets/liabilities would also apply under IFRS.

During its discussions on service concessions, the IFRIC considered a paper, based on the guidance in FAS 71, on the accounting treatment under IFRS of regulatory assets and liabilities, but no firm conclusions were reached except that any regulatory asset would need to meet the definition of an asset in the IASB’s Framework and other IFRSs.

Because IFRIC’s view that FAS 71 may not be applicable under IFRS related to regulatory assets only, the position with respect to regulatory liabilities remained unclear. The remaining part of this document therefore will focus on regulatory liabilities.

In practice, there is still divergence of views with respect to the accounting treatment of regulatory liabilities. And although the issue is limited to a selected number of companies that operate in regulated industries, such as the utilities sector or air traffic control, it is an issue in several countries and therefore raises the question of consistency of application on a cross-border basis.

Fact pattern

Company X, the owner of electricity transmission infrastructure and related assets, has been appointed as a Transmission System Operator (“TSO”) in a particular country. The

Company operates under license and is compensated for its operating services on the basis of regulated prices.

The TSO is appointed by the Government and such appointment is valid for a period of 20 years. The Electricity Law provides that only one system operator is authorised to manage and operate the transmission system.

As required by EU law, the local electricity market is monitored and controlled by independent regulators. The regulator is required to approve the prices that the company charges to its customers for access to the network. Pricing structures are defined in the law and related guidelines, determined on a 'cost-plus' basis based on budgets. Once approved, prices are published and apply to all customers. Prices are not negotiable with individual customers.

The regulator also requires the company to abide by any specific provision of the law or any related regulations, failing which it can impose administrative fines.

To ensure optimal operation, necessary investments and viability of the company's network and to allow it to provide an appropriate return to shareholders, prices are set to allow the company to achieve a fair return on its invested capital and recovery of all reasonable costs incurred, including borrowing costs.

At the end of each year, the company reports deviations between the actual results and the budgeted results. In the fact pattern under discussion, the company's actual results were significant above budget, i.e. the company made an excess profit significantly above the rate of return set by the regulator.

The regulator evaluates the actual results and resulting deviations and, by regulation, requires the company to hand back its excess profit achieved in the current period through price adjustments in the next period.

IFRS analysis

The hierarchy in paragraphs 10 and 11 of IAS 8, Accounting Policies, Changes in Accounting Estimates and Errors requires that accounting policies be determined in first instance based on requirements and guidance of Standards and Interpretations dealing with similar and related issues and the definition and principles in the Framework, and in second instance by reference to the pronouncements of any other GAAP provided that its conceptual framework is similar to the IFRS Framework.

In order to determine whether it is appropriate to recognise a regulatory liability under IFRS, it is necessary to consider other current standards that require the recognition of a liability. In doing so, it is also necessary to consider whether such a liability would meet the definition in the IASB's Framework. The alternative approaches, together with an analysis under each relevant standard, would be:

- deferred income under IAS 18
- financial liability under IAS 32
- provision under IAS 37

Analysis under IAS 18

View 1 – No deferred revenue

There is an arrangement with the regulator on the pricing of services to be provided by the company to its customers, and this arrangement will result in reduced revenues in future periods. However the services are provided to customers under separate contracts. Revenue under those contracts is recognised under IAS 18 when the services are provided. Since those contracts do not provide for surplus revenues to be returned to the individual customer, it is likely that the amount of revenue under each contract can be reliably measured, and it is probable that the amounts due from each customer will be received. Therefore it is doubtful whether there is a strong basis for deferring the recognition of revenue or income under IAS 18 or IAS 11.

View 2 – Deferred revenue

The arrangement sets out (in the license or concession agreement) a fixed or determinable amount of total revenue that the company is permitted to earn during the term of the arrangement. The company charges individual customers on a periodic basis essentially as a collection mechanism. However, under IFRSs the company should estimate the total revenue it will earn from the arrangement and the totality of the services it will be required to perform, and recognise revenue as it performs the services. If at any point in time the proportion of total revenue that the company has collected from individual customers exceeds the proportion of total services that it has provided, then the company should not recognise the excess receipts as revenue but has deferred income.

Analysis under IAS 32

No financial liability

IAS 32.11 defines a financial liability as: “*any liability that is: [...]*”

(a) a contractual obligation:

- (i) to deliver cash or another financial asset from another entity; or*
- (ii) to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or [...]*”

The arrangement with the regulator that requires the return of excess profits to customers may or not be a contractual arrangement. However, even if it is a contractual arrangement, the contract would not meet the definition of a financial liability because the utility company has no obligation to deliver cash either to the regulator or to its customers. In most cases, the obligation will simply be to reduce future prices, and if a customer stopped using the service, no rebate would be paid.

Note: in some arrangements, the regulator may have the power to require the company to pay cash to the regulator if revenues exceed a defined amount, or if the company’s return exceeds a defined level. In such cases, the company may have a financial liability due to the regulator. Even if the usual practice is for the regulator to direct the company to re-invest excess proceeds, or re-set prices, the company will have a financial liability if the regulator has the power to require the company to deliver cash.

In other arrangements, the company may be obliged to rebate cash to individual customers, such that a financial liability exists as a result of an explicit or implicit

inclusion of the requirements in the regulation into the terms of the contract with each customer.

Analysis under IAS 37

IAS 37.10 defines a liability as: “*a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits*”.

View 1 – No obligation or contingent liability only

Under one version of this view, there is an obligation, arising from the arrangement with the regulator, but the existence of the obligation is contingent on an uncertain future event: the future sale. If a sale is made in the future period, a rebate will, in effect, be paid. The obligation would therefore meet the definition of a contingent liability in IAS 37.10 (a): “*a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity*”.

Alternatively, it can be argued that the obligating event is the future provision of electricity to customers. If no customer purchased any utility service the following years, then the company would retain the gain on the operating costs. Under this approach, there is no obligation under IAS 37, either contingent or otherwise.

IAS 37.18 provides that: “*Financial statements deal with the financial position of an entity at the end of its reporting period and not its possible position in the future. Therefore no provision is recognised for costs that need to be incurred to operate in the future.*”

An interesting comparison might be with a warranty provision that, in accordance with IAS 37, is recognised as a liability when an entity has an obligation to repair or replace merchandises sold to customers during a specified period of time. This is also an obligation that a company incurs towards a large number of customers (“*public at large*”). However the past obligating event, the sale of a good to the customer, has already occurred which supports the recognition as a liability.

Another relevant comparison might be sales discounts. In the consumer products business, at the end of year N, suppliers and retailers negotiate trade agreements for year N+1 whereby the level of discounts for next year are determined and will contractually apply to both parties. These are negotiated based on the achievement/performance of the ending year and a significant amount of future sales might, from past experience, be highly likely. However these discounts are costs relating to future sales and in that instance they do not meet the definition of a liability.

Under this view, depending on what is considered to be the obligating event, there is either no obligation or a contingent liability. IAS 37.27 precludes the recognition in the balance-sheet of contingent liabilities. However IAS 37.86 requires disclosures at the balance-sheet date for each class of contingent liability. In this particular context, an appropriate disclosure would be necessary to provide the user of the financial statements with the appropriate information.

View 2 - Provision

Under View 2, the obligation of the company to return the excess profit to customers via future decreases in tariffs meets the definition of a liability. It is important to note that under this view, the party to whom the obligation is owed is ‘the public at large’ (or the entire present and future customer-base), unless there are specific contractual arrangements that would require a rebate to be paid to individual customers.

IAS 37.20 provides that: “*An obligation always involves another party to whom the obligation is owed. It is not necessary, however, to know the identity of the party to whom the obligation is owed – indeed the obligation may be to the public at large*”.

From the perspective of the public at large, the definition of a liability would be met as:

- A past event has taken place: the excess charge to customer, as a result of the difference between the budgeted costs and revenues and the actual figures;
- The past event, based on the contractual arrangement with the regulator, gives rise to a present obligation to return the gain to present and future customers; and
- The outflow (reduction in future revenue inflows) is probable.

An additional argument in favour of this view is by reference to IAS 18.

IAS 18.7: “*Revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increases in equity, other than increases relating to contributions from equity participants.*”

Under this view, it can be argued that amounts to be returned to customers in the future will never flow or be available to the entity except on a temporary basis (any excess cash received this year will be returned next year) and as such do not meet the definition of equity in the Framework paragraph 49: “Equity is the residual interest in the assets of the entity after deducting all its liabilities”.

IAS 18.20: “*When the outcome of a transaction involving the rendering of services can be estimated reliably, revenue associated with the transaction should be recognized by reference to the stage of completion of the transaction at the balance sheet date. The outcome of a transaction can be estimated reliably when all the following conditions are satisfied:*

- *the amount of revenue can be measured reliably;*
- *it is probable that the economic benefits associated with the transaction will flow to the enterprise;*
- *the stage of completion of the transaction at the balance sheet date can be measured reliably; and*
- *the costs incurred for the transaction and the costs to complete the transaction can be measured reliably.”*

Under this view, the amount of revenue can be measured reliably. However, it is not probable that the portion of the economic benefits relating to the excess profit will flow to the enterprise, as the regulations governing the activity requires a transfer back to customers of that portion of revenue in future fiscal years. It would not be a true and fair presentation of the performance of the company not to recognise this liability.

This view is in accordance with US GAAP FAS 71 which requires recognition of a liability.

In more extreme cases, regulated prices may be reduced prospectively to such an extent that the company estimates that it will record losses over the residual term of its license. In such circumstances, the license may become an onerous contract for which the company should provide.

Question for the Roundtable:

- 1) Do you agree that the issue of regulatory liabilities causes divergence in practice and therefore should be forwarded to the IASB for its consideration, either by IFRIC or in one of its current Board projects (e.g. on Revenue or Non-Financial Liabilities)?

ISSUE 2

IAS 17 Leases – exercise of renewal/extension option

Proposed by: FEE

The issue

IAS 17 *Leases* does not clearly address the accounting consequences of the exercise of a renewal or extension option. The issue is relevant where a lease includes an explicit renewal or extension option at inception the exercise of which was not considered reasonably certain (at inception).

For example, an entity might lease an asset for a 4 year term, with an option to continue the lease for a further 4 years. The economic life of the machine is 8 years. At inception, the lessee considers the likelihood of it exercising the extension option and determines that is not reasonably certain. The lease term is therefore 4 years (not 8) in accordance with the definition of lease term in IAS 17. In this scenario, depending on other factors, it is entirely possible that the lease would be classified as an operating lease.

The problem arises if the lessee subsequently exercises the option. The revised lease term covers the entire remaining economic life of the asset. The lease now has the characteristics of a finance lease. However, the lease would be (re-)classified as a finance lease only if:

- (i) the lease is reassessed on exercise of the extension option (or at some earlier point); or
- (ii) the extension period is considered a new lease.

Otherwise, operating lease accounting will apply for the full 8 years.

Is reassessment required?

IAS 17 paragraph 13 states that:

*Lease classification is made at the inception of the lease. If at any time the lessee and the lessor agree to change the provisions of the lease, **other than by renewing the lease**, in a manner that would have resulted in a different classification of the lease under the criteria in paragraphs 7-12 if the changed terms had been in effect at the inception of the lease, the revised agreement is regarded as a new agreement over its term. However, changes in estimates (for example, changes in the estimates of the residual life or the residual value of the leased property), or changes in circumstances (for example, default by the lessee) do not give rise to a new classification of a lease for accounting purposes [EMPHASIS ADDED]*

Paragraph 13 therefore requires reassessment (in effect) when a lease agreement is amended other than by renewal. It also appears to prohibit reassessment in any other circumstances. If the exercise of a pre-existing extension option is considered to be the same as renewing the lease, paragraph 13 seems to prohibit reassessment.

However, some regard the phrase "other than by renewing the lease" as ambiguous. For example, does it apply only if the lease is renewed on the same terms? Does it apply both to the exercise of an option in the lease and also to an extension negotiated some time after inception?

Supporters of reassessment also cite that fact that IFRIC 4 addresses the question of extension options in the context of assessing whether an agreement contains a lease in the first place. IFRIC 4 paragraph 10 requires that:

A reassessment of whether the arrangement contains a lease after the inception of the arrangement shall be made only if any of the following conditions are met:

...

(b) A renewal option is exercised or an extension is agreed to by the parties to the arrangement, unless the term of the renewal or extension had initially been included in the lease term in accordance with paragraph 4 of IAS 17. A renewal or extension of the arrangement that does not include modification of any of the terms in the original arrangement before the end of the term of the original arrangement shall be evaluated under paragraphs 6-9 only with respect to the renewal or extension period.

If the view is taken that exercise of the option triggers reassessment, a secondary issue arises as to what is being reassessed. Is it the entire agreement, or just the additional period and payments covered by the extension? This might be relevant when the lessee gives notice of exercise some time before the expiry of the original lease term.

(It is of course the case that IFRIC 4 is an interpretation of IAS 17, not the other way round, and also covers the existence of a lease not its classification).

Is extension period a new lease?

Some commentators argue that a new lease comes into being on exercise of an extension option that was not considered reasonably certain at inception (and accordingly not included in the lease term) is exercised. Accordingly, a new classification assessment is performed for the renewal period only. Supporters of this view argue that IAS 17 does not address the extension period. Rather, paragraph 13 applies only to the original lease term. If the extension period is regarded as not addressed by IAS 17 an accounting policy is developed that meets the criteria in IAS 8 (paragraphs 10 to 12). It might be argued that a "new lease treatment" is necessary under this approach because the renewal period was not taken into account for the classification of the original lease. Furthermore, an operating lease classification would not be appropriate. This is on the argument that an operating lease classification is not representationally faithful if the effect of exercising the option is that the lessee then has substantially all the risks and rewards of the underlying asset. Others might therefore refer to US GAAP by analogy in developing an accounting policy. Paragraph 9 of SFAS 13 is explicit on this issue. It states (emphasis added):

If at any time the lessee and lessor agree to change the provisions of the lease, other than by renewing the lease or extending its term, in a manner that would have resulted in a different classification of the lease had the changed terms been in effect at the inception of the lease, the revised agreement shall be regarded as a new agreement over its term and the criteria in paragraphs 7 and 8 shall be applied for the purposes of classifying the new lease. Likewise . . . any action that extends the lease beyond the expiry of the existing lease term (see paragraph 5(f)), such as the exercise of a lease renewal option other than those already included in the lease term, shall be considered as a new agreement,...

Others find these arguments to be in conflict with IAS 17. Paragraph 13 is interpreted as implying or requiring that the renewal of the lease by way of exercise of the option is still the same lease. Supporters of this view argue that the extension/renewal of the lease is merely a component of the initial lease, in which case it will follow the classification of the initial lease.

IFRIC 6 – Waste of Electrical and Electronic Equipment (WEEE)

Proposed by: **BUSINESSEUROPE**

1. Introduction

In 2005 IFRIC issued Interpretation IFRIC 6 - Liabilities arising from Participating in a Specific Market – Waste of Electrical and Electronic Equipment. The Interpretation addresses the question when a liability for decommissioning of WEEE should be recognized. The EU Directive 2002/96/EC that regulates the decommissioning of WEEE distinguishes four categories of waste. Waste from private households is distinguished from waste from other sources and historical waste is distinguished from new waste (products sold after August 13, 2005). The Directive states that the cost of WEEE for historical household equipment shall be borne by producers of that equipment who are in the market in a certain period. Such a model can also be enacted for future waste but the Directive leaves it to Member States to determine the funding model(s) that is to be applied to future waste. The consensus of IFRIC 6 is that a liability for historical household waste is linked to participation in the market during the measurement period. This consensus is clear and no inconsistency in application is to be expected.

2. New waste

IFRIC did not specifically address the responsibility for new (future) waste or the responsibility for waste originating from other sources than private households. According to IFRIC the liability for such waste is adequately covered in IAS 37. In some Member States national accounting standard setters have issued or drafted guidance that addresses new waste. In Germany Accounting Interpretation 2 was issued by the AIC and in the Netherlands a draft Guideline has been issued for public comment by the DASB. The legal structures that are implemented vary from country to country. In many Member States the management of producer responsibilities is organized through national recycling schemes initiated by industry associations. In some cases pan-European structures have been established like the European Recycling Platform (ERP) to promote cost-efficient and innovative recycling strategies and opportunities for pan-European recycling. In accordance with the directive most Member States have introduced the possibility to recover the cost of this waste through a visible fee that is added to the price of the product.

3. Does accounting for new waste lead to interpretation issues?

As yet it is difficult to conclude whether the lack of local guidance in some countries, or possible differences between local guidance in certain countries, will result in inconsistent application. The risk of inconsistencies appears to be remote for Member States that have enacted a funding model for new waste that is identical to the model for historical waste (IFRIC 6 can be applied in accordance with paragraph 7 of the Interpretation). When other funding models are introduced the companies involved will have to use the guidance in IAS 37 to determine the appropriate accounting treatment for their WEEE responsibilities. Discussions with important market participants indicate that the responsibility for dealing with WEEE, including the related accounting, is delegated to the operating companies in the Member States. To date there are no indications that unresolved accounting issues arose in this area, which would indicate that the companies involved are able to determine the appropriate accounting on the basis of IAS 37 or IFRIC 6, and that there is no need for additional guidance from IFRIC. The attention that is paid to WEEE in the accounting policies or notes to the financial statements of the companies involved is still limited, which makes it difficult to come to a positive assessment that no inconsistencies exist. However, at this moment in time there are no issues that require the attention of the IFRIC.

ISSUE 4

Parent company guarantees over subsidiary pension scheme and other liabilities

Proposed by: FEE

It is common for a parent company to write a "guarantee" to a third party in respect of certain obligations of a subsidiary. One example that occurs frequently in practice is a parent guarantee of a subsidiary's pension obligations. The guarantee is that the parent will fund the scheme if the subsidiary fails to make the payments that it is required to in respect of the scheme's funding. The beneficiary of the guarantee is the pension scheme. In jurisdictions where sponsoring employers are required to make risk-adjusted contributions to a pension protection scheme, the guarantee can reduce the required contribution rate. This paper considers various possible views of how such guarantees should be classified and accounted for under IFRS in the **parent's separate financial statements**.

This paper focuses on pension guarantees, although similar issues arise in respect of parent guarantees of a subsidiary's:

- operating lease rentals;
- debt facilities;
- tax obligations etc.

View 1 - insurance contract

Under this view, the guarantee is an insurance contract to which IFRS 4 applies.

IFRS 4 defines an insurance contract as a contract under which one party accepts significant insurance risk from another party (the 'policyholder') by agreeing to compensate the policyholder if a specified uncertain future event adversely affects the policyholder.

For a parent guarantee, the insured event is the non-performance of the subsidiary. Appendix B to IFRS 4 lists examples of insurance contracts, which include (in paragraph B18(f)) contracts that provide compensation if another party fails to perform a contractual obligation. The non-performance would adversely affect the policyholder (i.e. the pension plan) because it would not receive the contributions due from the sponsoring employer (subsidiary).

To qualify as an insurance contract, it is also necessary that the guarantee transfers significant "insurance risk" (rather than or in addition to financial risks). Some argue that the parent guarantee does transfer significant insurance risk because non-performance by the sponsoring employer (subsidiary) could arise for a wide variety of reasons. Not all of those reasons relate to financial risk variables (e.g. cash flow problems, insolvency, increased pension payments due for actuarial reasons).

IFRS 4 does not prescribe the accounting requirements for insurance contracts. It does however require that an entity that has issued an insurance contract tests the carrying amount in its balance sheet for adequacy at each reporting date using a liability adequacy test. The minimum liability is that arising from the application of IAS 37.

View 2 - financial guarantee contract (FGC)

Under this view, the guarantee is a financial guarantee contract (FGC) within the scope of IAS 39. IAS 39 defines an FGC as "a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument".

It is not obvious that a sponsoring employer's obligations under a pension scheme are a "debt instrument". However, the term "debt instrument" is not itself defined in IFRS. Also, the requirements applicable to FGCs might be considered to be applicable by analogy. Some commentators consider that the contract is more analogous to an FGC if the pension obligation is defined contribution in nature.

The accounting for an FGC depends on whether the issuer (parent) has explicitly asserted that it regards such contracts as insurance contracts. If so, it **may** elect to apply IFRS 4 (IAS 39 paragraph 2(e)) - see View 1 above. Otherwise, the issuer records the FGC at fair value on initial recognition. Subsequently, the FGC is reported at the higher of the initial carrying amount less cumulative amortisation and the amount that would be determined under IAS 37 (IAS 39 paragraph 47(c)).

View 3 - derivative financial instrument

If the guarantee is neither an insurance contract nor an FGC, it is necessary to consider whether it is some other form of financial instrument to which IAS 39 applies. For example, the guarantee might be viewed as a derivative financial instrument. A derivative financial instrument has the following characteristics (IAS 39 paragraph 9):

- its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the 'underlying').
- it requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors.
- it is settled at a future date.

If regarded as a derivative, the parent would account of the guarantee at fair value through profit or loss. This might be considered unattractive, in part due to the significant difficulties in measuring fair value for an instrument of this nature.

Some argue that the guarantee is not a derivative because it is not possible to identify the "specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable" i.e. the underlying. However, even if the definition of derivative is not satisfied, the guarantee might be a non-derivative **financial liability**. It would then be initially accounted for at fair value and thereafter at amortised cost, reflecting any future changes in expected cash flows in the income statement (IAS 39 AG8).

View 4 - defined benefit plan that shares risks between various entities under common control

Another view is that the effect of the parent guarantee is the subsidiary's pension plan becomes a **defined benefit plan that shares risks between various entities under common control** as envisaged in IAS 19 paragraph 34. Some commentators believe this view is not appropriate because the parent is not a genuine participant in the scheme. There is possibly a stronger argument for this view if some of the parent's own employees are within the scheme.

IAS 19 paragraph 34 sets out specific guidance on the accounting for benefit plans that shares risks between various entities under common control. In the absence of any contractual agreement or stated policy for charging the net defined benefit cost to the parent, IAS 19 paragraph 34A requires that the parent accounts for its contributions payable. This would lead to a nil charge in any period in which the guarantee is not called. The disclosures required by IAS 19 paragraph 34B would be made in the parent's separate financial statements.

Such an approach is likely to be considered attractive to some due to its simplicity.

View 5 - contingent liability

If none of views 1 - 4 are accepted, the default position is probably that the guarantee is a contingent liability in accordance with IAS 37. Under IAS 37 (for a single guarantee), it is most likely that no liability would be reported unless a payment under the guarantee becomes probable.

[Note:

*This is only one example of many issues in relation to **separate financial statements (SFS)**. IAS 27 paragraph 4 defines SFS as supplemental statements in which investments in subsidiaries, associates and jointly controlled entities are accounted for on the basis of the investor's direct equity interest. IAS 27 also includes requirements on the disclosures. Elsewhere, IFRS includes only piecemeal guidance on specific recognition and measurement issues (e.g. IFRIC 11) but lacks a broad set of core principles.*

A set of core principles could serve both to clarify and to simplify the application of IFRS to SFS. Greater clarity is desirable particularly on how to account for many transactions between a parent and subsidiaries (which are frequently not on arm's length terms). IFRS might also be viewed as overly complex for SFS because the only substantive difference between consolidated and separate financial statements under IFRS is the accounting for investments in subsidiaries etc. Applying IFRS in a parent's separate statements is therefore often a complex and burdensome exercise, due for example to a need to record items such as intragroup loans and guarantees at fair value. Although many EU member states allow parent entities an option to use EU endorsed IFRS, but the current requirements appear to act as a disincentive to taking up this option (where available).]

Business combinations involving entities under common control that are accounted for using the pooling of interests method – comparative figures.

Proposed by: FEE

One method of accounting for business combinations involving entities under common control that is commonly used is the pooling of interests method.

Business combinations involving entities under common control are outside the scope of IFRS 3 *Business Combinations*. It is therefore necessary to apply the ‘hierarchy’ in paragraphs 10-12 of IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* in order to select an accounting policy for common control business combinations.

The FASB is regarded as satisfying the requirements of paragraph 12 of IAS 8 (“other standard-setting bodies that use a similar conceptual framework to develop accounting standards...to the extent that these do not conflict with the sources in paragraph 11”). FAS 141 requires common control business combinations to be accounted for using the pooling of interests method and sets out how that method must be applied. The rationale for the use of pooling of interests accounting is that there has been no change in ultimate control and the business combination is in substance a reorganisation of existing interests and not an acquisition of a business.

Under the pooling of interests method, the financial statements are prepared as though the assets and liabilities concerned had been transferred as of the beginning of the reporting period. FAS 141 requires financial information presented for prior years also to be restated in order to furnish comparative information.

It appears that the regulator in Italy has taken the view that when the pooling of interests method is used to account for common control business combinations, it is not permissible to restate financial information for prior years.

This view is in conflict with the rationale for using pooling of interests accounting. As noted above, under the pooling of interests method, the financial statements for the current period are prepared as though the assets and liabilities had been transferred at the beginning of the reporting period (even if, for example, the common control business combination did not occur until the final day of the period). It is illogical to prepare the current period’s financial statements on this basis and not to restate financial information for prior periods to make it comparable with the current period.

Furthermore, prohibiting the restatement of prior period information would seem to be inconsistent with the requirement in IAS 8 to apply changes of accounting policy retrospectively.

Finally, different positions on this issue taken by national regulators should be avoided if consistent application of IFRS in the EU is to be achieved.

ISSUE 6

Purchase accounting for acquiree's interests in associates in a business combination

Proposed by: ANONYMOUS

The issue

In business combinations it is not uncommon that the acquiree holds interests in associates accounted for by the acquiree using the equity method.

Paragraph 36 of IFRS 3 states that:

*The acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the **acquiree's identifiable assets, liabilities and contingent liabilities** that satisfy the recognition criteria in paragraph 37 at their fair values at that date, Any difference between the cost of the business combination and the acquirer's interest in the net fair value of the **identifiable assets, liabilities and contingent liabilities** so recognised shall be accounted for in accordance with paragraphs 51-57. [EMPHASIS ADDED]*

It is not clear from IFRS 3.36 whether the acquiree's interests in associates should be recognised at the acquiree's share of the full fair value of the interests in associates or the share of the fair value of the identifiable assets, liabilities and contingent liabilities in the associates.

As a consequence there is believed to be divergence in practice on this issue. Furthermore, as illustrated in the examples below, the divergence in accounting treatment could significantly impact the Financial Statements. It is therefore recommended that IFRIC is asked to clarify the accounting treatment on this issue.

IFRS analysis

View 1 – Recognition of investment in associates at the acquiree's share of the full fair value of the associates

IFRS 3.36 states that the acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the **acquiree's** identifiable assets, liabilities and contingent liabilities at their fair values at that date.

The acquiree's interest in an associate represents an identifiable asset like any other asset of the acquiree, and there are no exceptions in the standard from recognising the acquiree's investments in associates at the full fair value of the investment.

On the contrary, IFRS 3 B16 (a) and (b) states the following regarding the measures as fair values:

IFRS 3 B16 (a) *for financial instruments traded in an active market, the acquirer shall use current market values.* [i.e. full fair value of the financial instruments held]

IFRS 3 B16 (b) *for financial instruments not traded in an active market the acquirer shall use estimated values that take into consideration features such as price-earnings ratios, dividend yields and expected growth rates of comparable instruments of entities with similar characteristics.* [i.e. full fair value of the financial instruments held]

Furthermore, IAS 28.23 states that goodwill relating to an associate is included in the carrying amount of the investment. There is no justification for deviating from this requirement simply because the associate is purchased as part of a business combination and not in a separate acquisition.

Some believe that those supporting view 1 would also be inclined to see the equity method as a valuation method rather than a one-line consolidation method.

View 2 – Recognition of investments in associates at the acquiree's share of the fair value of the associates identifiable assets, liabilities and contingent liabilities

IFRS 3.36 states that the acquirer shall, at the acquisition date, allocate the cost of a business combination by recognising the acquiree's identifiable assets, liabilities and contingent liabilities that satisfy the recognition criteria in paragraph 37 at their fair values at that date.

An interest in an associate is in reality a residual interest in the net assets of the associate and consequently, when applying IFRS 3.36 to the acquiree's interests in associates, the acquirer should recognise the acquiree's residual interests in the assets, liabilities and contingent liabilities in the associates at their fair values.

There have been no transactions in the share of the associates as part of the business combination, and therefore, it is inappropriate to recognise the acquiree's share of the full fair value of the associate, thereby recognising internally generated goodwill in the associates, within the carrying amount of the acquiree's interests in associates.

In fact as illustrated in the attached examples view 1 could in certain circumstances lead to the recognition of negative goodwill in P&L together with subsuming internally generated goodwill in the associate within the carrying amount of the acquiree's interests in associates.

Some believe that those supporting view 2 would also be inclined to see the equity method as a one-line consolidation method rather than a valuation method.

Appendix worked out examples:

Scenario 1

Company A acquires 51% of the shares in Company B for a purchase price of CU 5.1 million. Company B has a number of investments in associates (30% investments).

As part of the purchase price allocation (IFRS 3.36) Company A has identified intangible assets not previously recognised by Company B of CU 6.023 thousands. Fair values of other identifiable assets, liabilities and contingent liabilities in Company B, including interests in associates are as illustrated below.

CU 1.000	View 1	View 2
Net fair value of identifiable assets, liabilities and contingent liabilities of Company B (excl. Interest in associates and intangible assets not previously recognised by Company B)	(220)	(220)
Fair value of intangible assets not previously recognised by Company B	6.023	6.023
Deferred tax on intangible assets (34%)	(2.047)	(2.047)
	<u>3.756</u>	<u>3.756</u>
Investment in associate:		
Fair value of identifiable assets, liabilities and contingent liabilities in associates	542	542
Additional fair value adjustments in associates to full fair value	8.097	-
	<u>8.639</u>	<u>542</u>
Company B's share of fair values in associates (30%)	2.592	163
Total fair value of identifiable assets, liabilities and contingent liabilities in Company B	<u>6.348</u>	<u>3.919</u>
Company A's share of fair values (51% acquired)	3.237	1.998
Purchase price	5.100	5.100
Goodwill	<u>1.863</u>	<u>3.102</u>

Scenario 2

Facts are the same as scenario 1 except that intangible assets not previously recognised by Company B amounts to CU 2.023 and consequently the purchase price is reduced to CU 1.1 million.

	View 1	View 2
CU 1.000		
Net fair value of identifiable assets, liabilities and contingent liabilities of Company B (excl. Interest in associates and intangible assets not previously recognised by Company B)	(220)	(220)
Fair value of intangible assets not previously recognised by Company B	2.023	2.023
Deferred tax on intangible assets (34%)	(688)	(688)
	1.115	1.115
Investment in associate:		
Fair value of identifiable assets, liabilities and contingent liabilities in associates	542	542
Additional fair value adjustments in associates to full fair value	8.097	-
	8.639	542
Company B's share of fair values in associates (30%)	2.592	163
Total fair value of identifiable assets, liabilities and contingent liabilities in Company B	3.707	1.278
Company A's share of fair values (51% acquired)	1.891	652
Purchase price	1.100	1.100
Goodwill / (negative goodwill)	(791)	448
	To be recognised in P&L	

ISSUE 7

Application of IAS 19 to the classification of compulsory industry-wide multi-employer pension schemes in the Netherlands

Proposed by: DUTCH ASB

The issue has been circulated separately.