

IFRS News

Emerging issues and practical guidance*

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New IFRIC guidance on transfer of assets from customers

Steve Ralls from PwC's Accounting Consulting Services central team explains the guidance in IFRIC 18, 'Transfers of assets from customers'.

How is an asset received from a customer in return for connection to a network or ongoing access to goods or services accounted for? There has been diversity in practice. Some entities have recognised the asset received at fair value; others at its acquisition cost of nil. Entities that recognised the asset at fair value either recognised the related income immediately or over a longer period. IFRIC 18 addresses this divergence.

What will IFRIC 18 change?

The contributed assets will be recognised initially at fair value, and the related income will be recognised immediately or over the relevant service period. This will be a significant change for some entities.

The interpretation also provides new guidance for the separation and recognition of the different components of a transaction. It may be applied by more than just those entities that receive assets from their customers. It might be relevant to any entity that has more than one delivery obligation.

The impact may be broader than just the utility and outsourcing situations referred to in the illustrative examples in the interpretation. Entities in other industries, such as telecommunications, should consider whether their accounting is affected by IFRIC 18.

What is the guidance?

The interpretation applies to agreements for the transfer of property, plant and equipment from a customer that must be used to connect the customer to a network or provide the customer with an ongoing supply of goods or services. The interpretation does not apply to government grants or service concessions.

The key issues are: Was an asset received? How should the asset be valued? How should the related income be recognised?

The interpretation requires that:

- An item transferred from a customer is recognised when it meets the definition of an asset in the Framework. All relevant facts are considered to determine whether the item is controlled and whether it is probable there will be future economic benefits.

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Cannon Street Press

This column appears for the first time in *IFRS News*, but is expected to be a regular feature. It summarises recent activity at the Board (in residence on London's Cannon Street). Hopefully, it will provide enough to keep readers in touch with developments without wading through too much detail.

IFRS 7, Investments in debt instruments

The Board discussed responses to the exposure draft 'Investments in debt instruments, published on 23 December 2008, at the January meeting. It decided not to proceed with the proposed amendments (requirement for additional disclosure) at this time. It will consider the issues addressed in the exposure draft as part of its broader project on improving the accounting for financial instruments.

Improving disclosures about financial instruments

The Board discussed responses to the exposure draft 'Improving disclosures about financial instruments', published in October 2008, at the January meeting. The amendments enhance disclosures about fair value measurements and liquidity risk of financial instruments. The Board decided that entities will be required in their 31 December 2009 annual financial statements to make the following disclosures:

- The level of the fair value hierarchy into which fair value measurements are categorised in their entirety based on a three-level hierarchy that is the consistent with FAS 157.
- To provide a reconciliation from beginning balances to ending balances for fair value measurements resulting from the use of significant unobservable inputs to valuation techniques.

- The movements during the reporting periods between different levels of the fair value hierarchy, and the reasons for those movements.
- A maturity analysis showing the remaining contractual maturities for financial liabilities, except for certain derivative financial liabilities (for example, trading) that should be disclosed in a maturity analysis on the basis of the information provided internally to key management.
- A maturity analysis for financial assets used in managing liquidity risk if it is important to users of financial statements to understand the liquidity risk of the entity.

Proposed amendments to IFRIC 9 and IAS 39

The Board did not discuss the exposure draft that it released on 22 December in its January meeting. It is expected to discuss this in the February meeting.

IFRIC 9 and IFRIC 16, 'Post-implementation revisions' ED

The IFRIC ED, released last month, clarifies that IFRIC 9 does not apply to combinations of entities under common control or formation of joint ventures; and removes the restriction that prohibits the hedging instrument being held by the foreign operation whose net investment is being hedged. Comments are due by 2 March.

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- The asset is recognised initially at fair value.
- The corresponding credit is revenue that is recognised in accordance with IAS 18.
- The entity receiving the asset determines whether the asset has been received in exchange for one or more separately identifiable services – for example, connection to a network, ongoing access to that network or a supply of goods or services through the network. Two features that indicate that a connection is a separately identifiable service are:
 - A service is delivered to the customer and represents stand-alone value for that customer.
 - The fair value of the service can be measured reliably.

The requirement for stand-alone value means the customer transferring the asset receives value from the connection separate from any other service received subsequently.

- Revenue is recognised when each separately identifiable service is delivered.
 - When only one service is provided, revenue is recognised when the service is performed. This might be when the connection is made and there is no further obligation, or as the ongoing services are delivered, when the connection is not a separate service.
 - When more than one service is provided, revenue should be allocated to each service using an appropriate method, such as relative fair value or cost plus a reasonable margin and recognised when each service is delivered.
- The same accounting is applied if cash is transferred and must be used to build an asset that must be used to connect a customer to a network.

The IFRIC applies prospectively to all transactions from 1 July 2009; it can be applied earlier if the relevant data is available. Reporters in the European Union will need to wait until the interpretation has been endorsed.



Beginner's guide: pensions

If you want to understand defined benefit pension plans (and you're under retirement age), try asking your parents. They mostly had them. Or try asking a civil servant, as many of them will still have them. The rest of us will largely rely on defined contribution pension plans, and it's not making us very happy in the current market. Pension accounting is either brutally simple for defined contribution plans or hugely complex for defined benefit plans. Julie Thomas takes a look at both types of plans and the accounting issues that result.

All pension plans are classified as either defined benefit or defined contribution. These are explained as follows:

- **Defined contribution plans**, are also known as 'money purchase plans'. The employer pays contributions into a fund. Contributions may be a percentage of salary or a fixed annual sum. Employees may have the choice of making their own contributions as well. The pension that the employee receives is determined based on the level of contributions and the amount earned by the investments made by the plan. The employer has no further obligation to the employee.

The accounting is straightforward. Contributions are recorded as expense as they are earned by the employee. The company may have an accrual for contributions earned by employees but not yet paid over to the fund.

Defined contribution plans are the norm today. Their simplicity and the ability to predict annual expenditure makes them attractive to employers. They leave the risk of poor investment performance to the employee.

- **Defined benefit plans**, also known as 'final salary plans', are more complex both in operation and accounting. The pension plan rules specify the amount of benefit an employee will receive, usually in relation to their final year's salary.

Example

A pensioner receives 1/60th of final salary for each year of pensionable service (ie, each year worked), up to a maximum of 40 years. If final salary is 100k, after 30 years of service, the pension is 100k final salary * 30 years service / 60 = 50k a year.

Management almost always sets aside a pool of assets to satisfy this pension promise. The company bears the risk of poor investment performance. The contributions to the asset pool are based on complex estimates by actuaries of the amount of the benefits that will be paid and investment performance.

Defined benefit accounting is by far the more complex of the two types. Companies promise to pay a fixed sum to their employees at a point in the future. At the time they make that promise, management does not know how long any individual employee will work, whether they will reach

retirement age, how long they will live beyond retirement age and what their final salary will be when they retire. A further uncertainty in the pension calculation is how well that pool of assets will perform – in other words, what return the assets will earn to satisfy the pension obligation. Defined benefit pension accounting attempts to estimate this uncertainty and spread the expense over the years that the employee will work for the company.

There are three significant things to be aware of in pension accounting: determining the pension deficit or surplus, working out the annual expense and making the comprehensive disclosures required. This beginner's guide will address all three.

The balance sheet and the pension deficit or surplus

The net balance sheet position is determined by comparing the plan assets to the estimated value of the defined benefit pension promise. Any excess of the pension obligation over plan assets is presented as a deficit. An excess of plan assets over the obligation may be an asset if the employer can recover a refund or reduce contributions in the future.

- The plan assets must meet the specific conditions laid out in IAS 19, 'Employee benefits', for them to be offset against the pension obligation. Plan assets may be bonds, shares or property (for example) and will be used to eventually pay pensioners. Plan assets are measured at fair value.
- The pension obligation reflects the future payments that the company has committed to make to pensioners. It is calculated by actuaries using various assumptions, addressed below. This number is the present value of expected future payments to pensioners.

Defined benefit plans may be funded or unfunded, although few companies have unfunded plans today. The plan assets in a funded plan are generally beyond the reach of the company or its creditors. Pension liabilities of unfunded plans are met out of the employer's own resources. Funded or unfunded status makes no difference to measurement of the defined benefit obligation.

Measurement of the obligation

The obligation, in simplest terms, is the estimate of the amounts that will be paid to pensioners, adjusted for the time value of money.

Example

The company employs 100 people today. All are expected to work for 40 years. Their current salaries are C1,000 a year. This is not expected to change over their working lives. Management estimates they each will draw a single year's pension entitlement and then die. Their pension will be 100% of their final salary. At the end of year 1, they will have earned 1/40 of their pension entitlement.

Ignoring the time value of money and any plan assets, the company records $1/40 \times C1,000 \times 100$ employees = 2,500 as an expense and a deficit in year 1.

This simple and unrealistic example highlights the uncertainties that surround the measurement of the defined benefit pension obligation. Management has to make assumptions about employee longevity, future salaries and continuing employment. Then management has to select an appropriate discount rate to reflect the time value of money between the time the service is rendered and the time the benefit is drawn. This example also assumes that the pension promise is not changed or terminated during the lifespan of the plan and the employees. This is also an unrealistic assumption, as many plans are modified or terminated.

Income statement charge

The income statement charge is recognised in the period in which the benefits are earned. It is broken down into a number of sub-components:

- **Current service cost** – the increase in the pension obligation as a result of employees working this year and hence earning more pension entitlement.
- **Interest cost** – the increase in the pension obligation, measured at present value, because the benefits are one year closer to being paid out. This is the discount rate (see below) at the start of the period multiplied by the present value of the pension obligation.
- **Expected return on plan assets** – the long-term expected interest on bonds, dividends on shares, and other revenue generated by the plan.
- **Past service costs** – if benefits are changed in the current period, this will affect the pension obligation in relation to employee services rendered in prior periods. This can be positive (ie, an expense) where benefits are improved or new benefits introduced. It can also be negative (ie, income), where existing benefits are reduced, although this is rare.
- **Curtailment gains or losses** – the company reduces the number of employees covered by the plan or reduces the future benefits they will earn.
- **Settlement gains or losses** – the obligation is entirely eliminated. For example, a company makes a lump-sum cash payment to employees in return for them giving up

their pension, or when assets and liabilities are transferred into a defined contribution plan.

These elements are largely based on estimates. These are corrected in subsequent years when more information becomes available. These corrections are described as actuarial gains and losses. The methods for showing the correction of assumptions are described below in 'recognising the unexpected'.

Predicting the future

Accountants are better at history than at predicting the future. They seek help from actuaries to calculate the pension obligation. Actuaries must make a number of estimates or 'assumptions', about key variables in their 'projected unit credit' model. Assumptions can be split into two types:

- **Demographic**, such as rates of employee turnover, early retirements and mortality, or when they think people are going to die.
- **Financial**, such as salary increases, inflation and the discount rate used to convert the stream of future benefit payments into a single net present value.

Note from the publisher

Readers will be comforted to know that the beginner's guide series is subject to extensive testing prior to publication. The test panel for this beginner's guide insisted that the guide was simply crying out for an actuary joke at this point. We offer up the following in the spirit of cooperation between the professions.

Q: How many actuaries does it take to change a light bulb?

A: How many did it take last year?

How many do you want it to take?

None, after credibility weighting, we have indications that the bulb is still lit.

None, the insurance department is not allowing any modifications to the bulb at this time

Have any of our competitors changed bulbs yet?

None, they prefer to leave us in the dark.

The same number that it took last year, adjusted for trending.

Q: How can you tell the difference between an introvert actuary and an extrovert actuary?

A: An introvert actuary looks at his shoes; an extrovert actuary looks at your shoes.

If you want to play at being an actuary, try www.deathclock.com to work out when you might die. A couple of the most significant assumptions are discussed below.

Mortality

Pensioners will draw benefits for longer and the pension obligation will increase as life expectancy increases. Most companies have revised their longevity assumptions upwards in recent years, and many have seen a significant increase in their pension obligation.

Mortality is one of the key assumptions that investors like to see. Management should go beyond simply quoting names of actuarial tables and technical adjustments. Many non-specialist users find it useful to see how long men and women are expected to live if they retire today or at some time in the future, including details of where the number of years changes depending on geographic, demographic and other factors.

Discount rate

The discount rate used to take account of the time value of money is based on high-quality corporate bonds – generally AA rated or higher. The currency and term of these bonds should correspond to that of the defined benefit obligation. Most corporate bonds are of a shorter life than the time period over which pensioners draw benefits, so it is often necessary to extrapolate corporate bond yields to the longer term of the pension obligation. If there is no deep market in corporate bonds, the rate on government bonds should be used.

The rate used is not based on the expected rate of return on plan assets. The choice of assets that the fund invests in does not affect the nature or amount of the obligation for future payments to pensioners. This obligation is independent of the choice of plan assets.

Recognising the unexpected

Actuarial gains and losses arise due to changes in actuarial estimates or differences between the actuarial assumptions in the previous valuation and what has actually occurred.

There are three ways to recognise actuarial gains and losses.

The first method allows a company to recognise actuarial gains and losses in full as they arise in the SORIE (or other comprehensive income).

The second method is to account for actuarial gains and losses by viewing estimates of pension benefit obligations as a range (or 'corridor') around a best estimate. If actuarial gains and losses fall within the 'corridor', this suggests that estimates and assumptions were reasonably reliable, so the actuarial gains and losses need not be recognised in profit and loss. In other words, the 'corridor' represents a tolerable margin of uncertainty. The corridor is 10% of the greater of:

- the present value of the defined benefit obligation, and
- the fair value of plan assets at the beginning of the financial year.

The actuarial gains and losses that fall outside of this 10% corridor are recognised as a minimum over the average remaining service period of the employees. Faster recognition is also allowed. The same basis is applied to both gains and losses, consistently from period to period. It is likely that the IASB will remove the corridor option at some point in the future, as the method is somewhat arbitrary and opaque, and inconsistent with the IASB's Framework.

The third method allows an entity to recognise actuarial gains and losses immediately and in full in the income statement. This is rare in practice due to the volatility it introduces, a volatility that is more a reflection of the difficulty in predicting the future than in the pension obligation itself. Despite this, it is this method that the IASB seems to prefer.

Disclosure

IAS 19 sets out extensive disclosure requirements for defined benefit pension plans. Investor groups have called for more transparent disclosures, especially around the sensitivity of the pension obligation to key actuarial assumptions such as discount rate and mortality. Both can be subject to wide variations across companies and can have a significant impact on the pension obligation. Improved disclosures, they argue, are essential to having a clear view of the risks and rewards arising from defined benefit schemes.

Current concerns

The current credit crisis has led to severe declines in the value of pension plan assets, offset to a varying degree by a fall in pension obligations as discount rates rise. Large deficits have been reported for many years, often one of the largest numbers on the balance sheet. The cost and risks of servicing these pension deficits have led many companies to close their defined benefit plans. Pension accounting is high on the agenda of the IASB and the Proactive Accounting Activities in Europe' (PAAinE) initiative. The inherent difficulty in measuring the obligation and accounting for it over decades has puzzled accounting theorists, who are struggling to come up with a better method.



Predictions for 2009

Steve Ralls, a director in PwC's Accounting Consulting Services central team, provides a few thoughts on what might happen this year. Steve is a self-confessed supporter of Chelsea Football Club – the relevance of this will become clear below.

Accounting

No one in business today will have seen anything like the economic conditions we are experiencing. The financial markets continue to be volatile, and the commodities markets seem to be headed in one direction: down (except for precious metals). The 'real' economy is hurting from the credit crunch and the knock-on effects of belt-tightening around the world. Recession has been confirmed in all of the major global economies.

Against this backdrop, the Board has the financial statement presentation and the revenue recognition projects on its agenda. These are not at first glance the types of project that are likely to excite the man on the street, and yet they are fundamental to understanding a company's financial position.

Financial statement presentation could change the way investors look at companies' earnings, assets and, most importantly, cash. What if the cash flow statement was to become the primary statement this year? Management might begin presentations with 'We have generated \$X million from trading operations this year....' rather than 'Earnings per share has increased by 10%'.

There is an old saying among analysts: 'Cash is a fact; profit is only an opinion.' With profit simply an opinion and shares being bought back at today's currently cheap prices, EPS may reveal little about a company's performance.

Revenue has always been seen as an important indicator of growth. However, there maybe an increasing focus on the ability to convert that growth to cash in hand.

Prediction 1

- The fundamentals of accounting will be in the spotlight again, with analysts increasingly focusing on companies' ability to generate cash.
- Companies will focus on what they do well and will exit or disengage from less attractive activities.
- 'True and fair' will have a much sharper focus.

Economics

Last month the US launched 'Obamanomics'. President Obama said "We don't ask whether Government is too big or too small but whether it works."

'Whether it works' requires a different approach from that

which we have seen from governments and companies during recessions in the past. Wholesale restructuring and cost reduction typically requires large reductions in head count. As one FD said in 1992: "It is surprising when you cut hard once, there is still much more you can cut. Cut and keep cutting." Clearly there is and will be restructuring, but management is likely to be more creative in how it approaches it.

Short working pioneered by manufacturing industries has spilled over into the services sector. It is based on enabling people do more of what they want – career breaks, reduced standard hours, home working, flexible working – but the main aim is cost reduction: cost reduction with an eye for the future. 'Good' people will always be in short supply and difficult to retain. Management wants to keep them, and so all sorts of options will be carefully explored, to see 'whether it works'.

Prediction 2

Painful lessons learned in previous downturns will keep management focused on minimising redundancies. They will be looking for new working models that will reduce costs, enable flexibility, encourage growth and 'work' for all.

And the best of the rest

- The most lucrative businesses will be:
 - Anything that can continue to command a premium for the brand.
 - Flexible, responsive, short lead-time service and manufacturing operations.
 - New world technologies that have low start-up costs, can piggy-back something currently successful and be an instant hit.
- The small entrepreneur will return to:
 - Service businesses, such as catering, cleaning and financial services boutiques.
 - Technology support.
- Zero-energy-use buildings will become the norm. They won't be pretty but will be in high demand.
- Chelsea FC will win the Premier League, FA Cup and Champions League; Manchester United crashes out of the Premier League and begins its descent to Conference*.
- The big three automotive manufacturers will be inspired to innovate at the same rate as the IT industry. Result: we will have a flying car that will cost \$100.

*The Conference League is bottom of the four tiers of the English football league

EU adoption status

The European Union adopted a number of standards in December. The tables below list the recently adopted standards and interpretations and the progress of those not yet adopted.

Standards/interpretations adopted by EU	Date of EU adoption	Effective date
IAS 1 (revised), 'Presentation of financial statements'	17 December 2008	1 October 2008. Early application permitted.
IAS 23 (revised) 'Borrowing costs'	10 December 2008	1 January 2009. Prospective application, but can be adopted from a date before the effective date.
Amendment to IFRS 2, 'Vesting conditions and cancellations'	16 December 2008	1 January 2009. Early application permitted.
IFRIC 13, 'Customer loyalty programmes'	16 December 2008	1 July 2008
IFRIC 14 'IAS 19 – the limit on a defined benefit assets, minimum funding requirements and their interaction'	16 December 2008	1 January 2008

Standards/interpretations not yet adopted	EFrag issued adoption advice?	ARC voted on it?
Amendments to IAS 32 and IAS 1, 'Puttable financial instruments and obligations arising on liquidation'	On 16 May 2008	On 6 November 2008
Amendment to IFRS 1 and IAS 27, 'Cost of an investment in a subsidiary, jointly controlled entity or associate'.	On 21 July 2008	On 6 November 2008
IFRS 3 (revised), 'Business combinations'	On 7 November 2008	No
IAS 27 (revised), 'Consolidated and separate financial statements'	No	No
Amendment to IAS 39, 'Eligible hedged items'	No	No
IFRIC 15, 'Agreements for construction of real estate'	On 3 November 2008	No
IFRIC 16, 'Hedges of a net investment in a foreign operation'	On 3 November 2008	No
IFRIC 17, Distributions of on-cash assets to owners	No	No

Key tax issues on transition to IFRS for pharma industry

PricewaterhouseCoopers' Pharmaceutical and Life Sciences group has released a webcast on tax hot topics for companies in the industry moving to IFRS.

'IFRS conversion: Understanding the key tax issues for Pharmaceuticals, Life Sciences and Medical Devices companies' addresses:

- Tax accounting methods, including LIFO, leases, advance payments, and component depreciation.
- International tax planning, including global structuring, debt planning, cash repatriation and foreign tax credits.
- Transfer pricing planning and documentation.
- Compensation, benefits and human resources.

- Milestones, IPR&D and tax reserves.

Among those who might be interested in this are: tax specialists, CFOs, financial controllers, finance directors and other functions with an expected role in IFRS conversions in Pharmaceuticals, Life Sciences and Medical Device companies. The recording can be downloaded from: <http://www.pwc.com/extweb/industry.nsf/docid/A688A7B65F0817AF8525752E00604248>



For further help on IFRS technical issues contact:

Marc Minet, Partner - IFRS Leader
marc.minet@lu.pwc.com +352 49 48 48-2566

Philippe Duren, Partner - Commercial and Industrial Companies
philippe.duren@lu.pwc.com +352 49 48 48-2515

Kenneth Iek, Partner - Investment Management & Real Estate
kenneth.iek@lu.pwc.com +352 49 48 48-5751

Claude Jacoby, Partner - Insurance
claude.jacoby@lu.pwc.com +352 49 48 48-2497

Gilles Vanderweyen, Partner - Commercial and Industrial Companies
gilles.vanderweyen@lu.pwc.com +352 49 48 48-5741

Marianne Weydert, Partner - Banking
marianne.weydert@lu.pwc.com +352 49 48 48-2566

Magalie Cormier, Director - Training Solutions
magalie.cormier@lu.pwc.com +352 49 48 48-5735

Fabrice Goffin, Director - Technical Advices and Banking
fabrice.goffin@lu.pwc.com +352 49 48 48-2529

Harald Thul, Director - Banking and Real Estate
harald.thul@lu.pwc.com +352 49 48 48-5717