

IFRS news

Emerging issues and practical guidance*

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Exposure draft on fair value measurement



The Board issued its long-awaited exposure draft, 'Fair value measurement', last month. The ED does not expand the use of fair value or say when to use fair value. It provides a single source of 'how to' guidance for measuring fair value where an IFRS requires or permits its use'. Robert Marsh in Global ACS in the US and Alberto Vieyra in the Global ACS Central Team look at the proposals.

The existing guidance on measuring fair value was developed on a piecemeal basis over many years and is dispersed across numerous standards. This single definition and framework aims to reduce complexity and improve consistency in the application of fair value measurements.

The ED is based on US standard SFAS 157, 'Fair Value Measurements'. The definition of fair value in the ED is identical to that in SFAS 157. The guidance is also largely consistent with US GAAP and the guidance issued by the IASB's Expert Advisory Panel in September 2008.

The ED proposes an exit-price notion of fair value, defined as "the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date". It provides additional guidance specifying:

- The transaction is assumed to take place in the most advantageous market for the asset or liability – that is, the market that maximises the amount that would be received to sell the asset or minimises the amount that would be paid to transfer the liability.
- Fair value measurement should take into account the assumptions and characteristics of the asset or liability that would be considered by market participants in pricing the asset or liability.
- The best evidence of fair value at initial recognition is the transaction price, except in the cases of related-party transactions, distressed transactions, different units of account and different markets.
- The fair value measurement of an asset should reflect its highest and best use, which is the use by market participants that would maximise the value of the asset or of the group of assets in which the asset would be used. (Financial assets do not have alternative uses.)

* The Board did identify three instances where the term fair value is used inconsistently with the proposed definition. In the cases of share-based payments and re-acquired rights in business combinations, the proposal is simply to remove 'fair value' from the existing standards. The third instance identified, the measurement of financial liabilities with a demand feature, is dealt with via a scope exception in the proposed fair value measurement standard itself.

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The ED differs from SFAS 157 in that it defines the reference market as the most advantageous market. SFAS 157 assumes that the transaction takes place in the principal market if one exists. However, the ED notes that the entity may assume that the principal market is the most advantageous if there is no evidence to the contrary.

Unit of account

The ED does not change the unit of account prescribed by existing IFRSs. The unit of account for financial assets and liabilities therefore remains the individual instrument.

Fair value of liabilities

The ED proposes that the fair value of a liability reflects non-performance risk (including the reporting entity's own credit standing). Non-performance risk is also assumed to be the same before and after the transfer of a liability; the definition of fair value assumes that, because the liability is transferred, the liability continues and is not settled with the counterparty or extinguished in any other way. The fair value of a liability is equal, in the Board's view, to the corresponding asset held by the counterparty. A liability is therefore measured using the same method that would be used by the counterparty to measure the asset, even in the absence of an observable market price. This is one area where the proposals might change the way in which some entities measure the fair value of some of their liabilities.

Fair value hierarchy

The ED proposes a single fair value hierarchy like that in SFAS 157, which will apply to all fair value measurements. The hierarchy has three levels, based on the type of inputs to the valuation techniques used.

- Level 1 inputs are quoted prices in active markets for items identical to the asset or liability being measured.
- Level 2 inputs are other observable inputs.
- Level 3 inputs are unobservable inputs but must be developed to reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability. Each fair value measurement is categorised based on the lowest level input that is significant to it.

The ED does not prescribe the use of bid prices for assets and ask prices for liabilities; it requires the use of judgement in determining which price within the bid-ask spread is most representative of fair value in the circumstances. This holds true no matter where in the hierarchy the inputs based on the bid and ask prices reside. This is a change from existing guidance.

Disclosures

There are enhanced disclosure requirements, which could result in significantly more work for reporting entities. These requirements are similar to those in IFRS 7 but apply to all assets and liabilities measured at fair value, not just financial assets and liabilities. The disclosures requirements include:

- Information about the hierarchy level into which fair value measurements fall.
- Any significant transfers between levels 1 and 2.
- Methods and inputs to the fair value measurements and changes in valuation techniques.
- Additional disclosures for level 3 measurements that include a reconciliation of opening and closing balances.

The proposals include a requirement for financial instruments to have the same disclosures in interim statements as for annual statements. This is likely to have the biggest impact on financial institutions.

Fair value measurement ED – at a glance

- The proposed standard does not require additional fair value measurements. It provides a single source of guidance that explains how to measure fair value.
- The proposals more closely align IFRS and US GAAP in some areas, such as the application of a single three-level hierarchy to all fair value measurements.
- Enhanced disclosure requirements could result in significantly more work for reporting entities.
- The proposals define fair value as an exit price.
- Comments are due by 28 September.

Cannon Street Press

IASB to expose IAS 39 in three drafts

The Board decided at its meeting last month that the replacement standard for IAS 39 will be exposed in three drafts. The first will focus on the classification and measurement of financial instruments (expected July 2009); the second and third will deal respectively with impairment (expected October 2009) and hedging (expected Q1, 2010).

Classification and measurement

The IASB tentatively decided that the two measurement categories will be fair value and amortised cost. Basic financial instruments (as set out in 'IFRS for SMEs') will qualify for amortised cost; all other financial instruments will be measured at fair value. Entities may then have an option to fair value some of those basic financial instruments if, for example, the entity's business model was to trade the instrument. This might be a free choice or may be subject to constraints. There might be other items that are required to be fair valued – for example, those basic financial instruments that are quoted in an active market.

These issues will be considered at future meetings. The Board will propose to prohibit reclassifications between the fair value and amortised cost categories; eliminate tainting rules (but require separate presentation of gains and losses on disposals

of amortised cost instruments); and allow presentation of fair value changes in other comprehensive income but without recycling or impairment (although the basis on when this would be permitted was not discussed).

Impairment

The Board discussed the various approaches to impairment. The staff is currently discussing the mechanics of an expected loss approach (by contrast to the current incurred loss model) to impairment with various stakeholders. The Board is expected to ask for views from interested parties via the website posting in July, in anticipation of issuing an exposure draft on impairment in October 2009.

Draft amendments to IFRIC 14

The Board has published an exposure draft proposing amendments to IFRIC 14, 'IAS 19 – The limit on a defined benefit asset, minimum funding requirements and their interaction'. The proposed amendment is aimed at correcting an unintended consequence of IFRIC 14. Some entities will not be permitted to recognise as an asset certain pre-payments for minimum funding contributions. The proposals will remedy this by requiring pre-payments in appropriate circumstances to be recognised as assets. There is a 60-day comment period, ending 27 July 2009.

Start of a new term at IASB and IFRIC

The IASB and IFRIC have appointed new members from next month. Amaro Luiz de Oliveira Gomes from the Central Bank of Brazil, and analysts Patrick Finnegan from the CFA Institute Centre for Financial Market Integrity and Patricia McConnell from Bear Stearns join the board as full-time members for five years. Laurence Rivat joins IFRIC for three years from Deloitte in France.



Amaro Luiz de Oliveira has played a leading role in the adoption of IFRSs in Brazil, overseeing their introduction for financial institutions. He has also served as a member of the Brazilian Committee of Accounting Standards and the Steering Committee for Accounting Convergence – Brazil, and on the

Accounting Task Force of the Basel Committee on Banking Supervision.



Patrick Finnegan leads a team at CFA Institute (association for investment professionals) providing user input into the standard-setting activities of the IASB, FASB and other regulatory bodies. He has also co-ordinated the work of the CFA Institute's Corporate Disclosure Policy Council, which reviews

and comments on financial reporting policy initiatives around the world. He was previously managing director in Moody's Corporate Finance Group.



Patricia McConnell is one of the leading analysts in the US on accounting-related issues. During her 32 years at Bear Stearns' Equity Research group, she has participated in standard-setting activities as a member of the IASB's Standards Advisory Council, the IASC, the CFA Institute's Corporate Disclosure Policy Council, and the New York Society of Security Analysts.

Laurence Rivat is a Deloitte partner in the firm's IFRS leadership team and heads up one of its 'IFRS centres of excellence'.

IFRIC has also announced the reappointment, for three years, of:

- Sara York Kenny, Consulting Advisor, International Finance Corporation (World Bank Group).
- Takatsugu Ochi, Assistant General Manager, Financial Resources Management Group, Sumitomo Corporation.
- Ruth Picker, Partner and Global Director, Global IFRS Services, Ernst and Young.



Beginners' guide: intangible assets



Coca-Cola's secret formula, McDonald's golden arches, Mickey Mouse, the *Times* subscriber list – these are all forms of intangible asset. The 'Spirit of Ecstasy', the famous flying lady that adorns the front of every Rolls-Royce, was at the centre of tussle between VW and BMW that demonstrates the power of a trademark.

Coca-Cola's secret formula is priceless. Disney's brand power embodied in

Mickey Mouse is world class. However, the accounting for these intangible assets can be complicated. It has been made more difficult by the current economic climate. Management has been focusing on these assets and assessing whether their value is recoverable. Larry Dodyk and Eric Kahrl of PwC's Accounting Consulting Services in the US try to make intangible assets a bit more tangible.

What is an intangible asset?

An intangible asset is defined as an 'identifiable non-monetary asset without physical substance'. Unlike tangible assets such as factory equipment or an office building, intangible assets derive their value from the rights and privileges granted to the company using them.

Management frequently expends resources or incurs liabilities on the acquisition, development, maintenance and enhancement of intangible resources. These include scientific and technical knowledge, design and implementation of new processes and systems, licences, intellectual property, market knowledge and trademarks (including brand names and publishing titles).

Intangible assets can take on many forms. They typically fall into one of six categories:

- Marketing-related: trademarks, trade names, service marks, collective marks, newspaper mastheads, internet domain names and non-competition agreements.
- Customer-related: customer lists, order and production backlog, customer contracts and related customer relationships, and non-contractual customer relationships.
- Artistic-related: plays, operas, ballets, literary works, musical works, pictures, photographs, video and audiovisual material.
- Contract-based: licensing and royalty agreements, advertising contracts, service and supply contracts, lease agreements, franchise agreements, broadcast rights and employment contracts.
- Technology-related: patents, trade secrets, databases and computer software.
- Goodwill.

Management has to use judgement to determine if expenditures meet the definition of an intangible asset. An intangible asset must be 'identifiable', controlled and capable of generating future economic benefits, according to the definition in IAS 38, 'Intangible assets'.

An asset is 'identifiable' if it is separable (that is, it is capable of being separated or divided from the entity and sold, transferred,

licensed, rented or exchanged, either individually or together with a related contract or asset/liability). An asset is also 'identifiable' if it arises from contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or other rights.

How is an intangible asset recognised?

Intangible assets might be internally generated, acquired as part of a business combination or acquired separately. The accounting can be very different depending on how the asset was acquired. So how does the method of acquisition impact the initial recognition and measurement of intangible assets?

Recognition and measurement of internally generated intangible assets

Many intangible assets are internally generated; that is, they are established and supported by management over a long period of time. Most brand names are internally generated and it can be difficult to spot the moment when a brand moves from a clever marketing idea to a value generator. Brands associated with consumer products tend to be the most valuable, as they can allow management to charge a premium price for a product that would otherwise have little differentiation, such as cigarettes or vodka. Expenditures on brand development cannot be distinguished from the cost of developing the business as a whole; they are not separable. Such items are not therefore recognised as intangible assets when developed internally.

Intangible assets of a more technical or scientific nature such as software or patented drugs may also be developed internally by a company. The process of generating this type of intangible asset is divided into a research phase and a development phase. Research is the discovery, interpretation and development of knowledge. Development is the application of knowledge to specific problems. No intangible assets arising from the research phase may be recognised. This is because during the research phase it is not possible to establish probable economic benefit attributable to the research expenditure.

An entity can, in some instances, identify an intangible asset during the development stage and demonstrate that the asset will generate probable future economic benefits. Intangible assets arising from the development phase are recognised when the entity can demonstrate all of the following:

- Its technical feasibility.
- Its intention to complete the developments.
- Its ability to use or sell the intangible asset.
- How the intangible asset will generate probable future economic benefits (for example, the existence of a market for the output of the intangible asset or for the intangible asset itself).
- The availability of resources to complete the development.
- Its ability to measure the relevant expenditure reliably.

Examples of development activities that might meet the criteria for capitalisation are:

- The design, construction and testing of pre-production or pre-use prototypes and models.
- The design of tools, jigs, moulds and dies involving new technology.
- The design, construction and operation of a pilot plant that is not of a scale economically feasible for commercial production.
- The design, construction and testing of a chosen alternative for new or improved materials, devices, products, processes, systems or services.

Any expenditure written off during the research or development phase cannot subsequently be capitalised if the project meets the criteria for recognition at a later date. The costs relating to many internally generated intangible items cannot be capitalised but are expensed as incurred. These include research, start-up and advertising costs.

Recognition and measurement of separately acquired intangible assets

A company may purchase an intangible asset from another party. Separately acquired intangible assets are recognised initially at cost. Cost comprises the purchase price, including import duties and non-refundable purchase taxes, and any directly attributable costs of preparing the asset for its intended use. Separately acquired intangible assets are common in the pharmaceutical industry, where both patented drugs and drugs in development will be bought and sold. Desirable take-off and landing times (slots) at a major airport also commonly change hands. Broadcast licences for television, radio and mobile phones may be acquired either from a governmental authority or another entity. Broadcast rights to movies and television programmes are another form of intangible that are bought and sold outside a business combination.

The purchase price of a separately acquired intangible asset incorporates assumptions about the probable economic future benefits that may be generated by the asset. A patented drug

that is being actively marketed will have a predictable stream of cash flows and will command a price commensurate with those expected highly probable (not so risky) cash flows. A pharmaceutical compound in early development will sell for a much lower price, reflecting the considerable uncertainty about whether it will be successful. Thus, probability is factored into the initial measurement of a separately acquired intangible asset.

Recognition and measurement of purchased as part of a business combination

The cost an intangible asset acquired in a business combination is its fair value at the acquisition date. The fair value of an intangible asset reflects expectations about the probability that the expected future economic benefits embodied in the asset will flow to the entity. As discussed above, more certain cash flows will result in a higher fair value and less certain cash flows in a lower fair value.

Most marketing- and customer-type intangible assets are only recognised as part of a business combination, as these types of assets would seldom change hands unless the entire business is sold. What would Coca-Cola be without the Coca-Cola brand?

If an intangible asset acquired in a business combination is separable or arises from contractual or other legal rights, there is sufficient information to measure reliably the fair value of the asset. The reliable measurement criterion is therefore also considered to be satisfied for intangible assets acquired in business combinations. If an intangible asset is not separable or does not arise from a contractual or legal right, the asset is recognised as part of goodwill.

An acquirer recognises at the acquisition date, separately from goodwill, an identifiable intangible asset of the acquiree, irrespective of whether the asset had been recognised by the acquiree before the business combination. Certain contract-related intangible assets may not have been recorded by a target in its pre-acquisition balance sheet, such as executory contracts. Upon acquisition, these contracts may reflect a favourable position relative to current market conditions and may therefore represent intangible assets. It may be challenging to identify these assets during a business combination across a large organisation.

How are intangibles measured subsequently?

Intangible assets are amortised unless they have an indefinite useful life. Management amortises the assets on a systematic basis over their useful life. An intangible asset has an indefinite useful life when there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. Indefinite is not the same as infinite (limitless in extent), nor is it the same as indeterminate (having no definable value). The useful life of a finite-life intangible asset is reviewed at least at each financial year end.

Management chooses either the cost model or the revaluation

Measurement bases			
Cash flows	Assumptions	Approach	
Value in use (VIU)	Must be a discounted cash flow	Based on management's assumptions	Tests the asset as it is today
Fair value less costs to sell the (FVLCTS)	Can be a discounted cash flow but can be based on market prices	Based on market participant assumptions	Tests the highest potential of asset

model as its accounting policy for intangible assets after initial recognition. There must be an active market for the revaluation model to be applied. As few intangible assets are actively traded, revaluation is seldom seen in practice.

Impairment and the current market

Management has been focusing on intangible assets in the economic downturn and whether their value is recoverable. An intangible asset cannot be carried at an amount that is higher than what may be recovered through use (value in use, or VIU) or sale (fair value less costs to sell, or FVLCTS). The higher of VIU or FVLCTS is the recoverable amount. Impairment results when the recoverable amount is less than the carrying amount. The two bases of measurement have similarities and differences, as shown in the table above.

Not all intangible assets have to be tested for impairment every year. Intangible assets with finite lives are tested only when there is an indicator of impairment. However, goodwill, indefinite-lived intangible assets and intangible assets that are not yet ready for use are tested every year and when there are indicators of impairment. Some indicators are operating losses, market downturns, damage and an intended change of use for the asset.

Intangible assets are most often tested for impairment in a cash-generating unit (CGU) or with groups of cash-generating units. For example, a major brand like Nike would generate cash flows for all branded products. A CGU is the smallest group of assets that generates cash inflows that are largely independent of those from other assets; it can also be a single asset. Typical CGUs are retail stores and factories. A CGU has assets that can be specifically allocated to it (for example, fixed assets within a store) and will include portions of central assets if these can be allocated on a reasonable and consistent basis.

Current economic conditions have brought recorded intangible assets and goodwill into the spotlight. There has been more scrutiny of what may have been 'routine' impairment testing for goodwill and indefinite lived intangibles. Widespread impairment indicators have results in impairment testing of amortising intangibles as many businesses have come under pressure. Good disclosure of impairment charges taken – and those avoided – will be key in the current reporting climate.

Intangible assets – the Rolls-Royce Motors

Rolls-Royce Motors (maker of both Rolls-Royce and Bentley) was created from the demerger of the Rolls-Royce car business from Rolls-Royce Limited in 1973. Vickers, owner of the car business, decided in 1998 to sell Rolls-Royce Motors. The leading contender seemed to be BMW, who already supplied engines and other components for Rolls-Royce and Bentley cars. Their final offer of £340m was outbid by Volkswagen, who offered £430m.

Who knew what and when remains uncertain to this day. However, it turned out that certain essential trademarks (the Rolls-Royce name and logo) had never been owned by Vickers but still belonged to Rolls-Royce Limited. Rolls-Royce Limited decided to license these to BMW not to Volkswagen. Volkswagen had bought rights to the 'Spirit of Ecstasy' mascot and the shape of the radiator grille, but it lacked rights to the Rolls-Royce name. BMW lacked rights to the iconic grille and mascot. BMW bought an option on the trademarks, licensing the name and 'RR' logo for £40m, a deal that many commentators thought was a bargain for possibly the most valuable property in the deal. VW asserted that it had only really wanted Bentley anyway. Bentley was the higher volume brand, with Bentley models out-selling the equivalent Rolls-Royce by around two to one.

BMW and VW hammered out a complex solution and finally, from 1 January 2003, only BMW was able to name cars 'Rolls-Royce', and VW's former Rolls-Royce/Bentley division would build only cars called 'Bentley'.



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