

**ROUNDTABLE**

**CONSISTENT APPLICATION OF IFRS**

**BRUSSELS, 20 SEPTEMBER 2006**

**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 20 September 2006. 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.**

**This paper should therefore only be read in conjunction with the Summary Meeting Report.**

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

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**CONSISTENT APPLICATION OF IFRS**

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**ISSUES PAPER**

***A. Brief overview of Issues Proposed***

***ISSUE 1 - IFRIC 9 Reassessment of Embedded Derivatives***

***Proposed by: EFRAG***

***IFRIC 9 has been issued by IFRIC but did not address this particular issue***

IFRIC recently issued IFRIC 9 to provide guidance on when to reassess and reclassify embedded derivatives. EFRAG recommended endorsement, but concluded that there are circumstances, e.g. Business Combinations, which could trigger a reassessment or reclassification, but are neither addressed in IFRIC 9 nor elsewhere in the IFRS literature. An interpretation could avoid divergence in practice (as US GAAP seems to give guidance in this respect which differs from the application by at least some constituents) before a final standard on Business Combinations (Phase II) is issued.

***ISSUE 2 - Waste of Electrical and Electronic Equipment (WEEE)***

***Proposed by: UNICE***

***IFRIC 6 has been issued by IFRIC but did not address this particular issue***

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 3 - Deemed cost of a subsidiary in first time application***

***Proposed by: OIC - Organismo Italiano di Contabilità***

***At its meeting in March 2006, the IASB decided to add a project to its technical agenda to resolve issues in relation to measuring the cost of a subsidiary in the individual financial statements of a parent on first time adoption of IFRSs. At the IASB May 2006 meeting the Board discussed potential amendments to IFRS 1 to resolve the issue and will probably re-debate it in the September meeting***

OIC raises the issue that the exemption in IFRS 1/IAS 27 for recalculating the initial cost of an investment in the case of first-time adopters is not available for separate financial statements. Whereas there is the option for other assets to use fair value or previous GAAP revaluation as deemed cost, there is no such option for investments which means that the initial cost of an investment has to be determined retrospectively. Jurisdictions such as Italy, where the separate financial statements of parent entities are to be prepared in compliance with IFRS, are therefore affected.

***ISSUE 4 - IAS 24 disclosure of post-employment benefit***

***Proposed by: EECS/CESR-Fin***

***Not already dealt with by IASB/IFRIC***

CESR raises an issue regarding disclosure requirements for key management personnel's compensation in the context of IAS 19 Employee Benefits and defined benefit plans. There are many ways to determine the amount and, in addition, the standard allows a number of options, e.g. how to account for actuarial gains and losses. The key question is therefore how should the "post-employment benefit" element of key management consideration be calculated? Should it be influenced by the accounting policy used to account for defined benefit plans under IAS 19? If so, how should the amount be derived? If not, what amount should be disclosed?

***ISSUE 5 - Common control transactions***

***Proposed by: Dutch Accounting Standards Board***

***Not already dealt with by IASB/IFRIC***

The Dutch raise the issue of accounting for business combinations under common control, which is excluded from the scope of IFRS 3. Furthermore they raise concerns about the boundaries of the scope exclusion in general and the question of how to account for any other transactions between entities under common control, e.g. spin-offs, split-offs or de-mergers if the group continues to have control. Specific questions have been brought to IFRIC but were not taken on board as it was felt that they could not deal with them within a reasonable timeframe. As common control transactions have not been dealt within phase II of the business combination project of the IASB and most probably will not be dealt within any other project, e.g. the conceptual framework project, within a reasonable timeframe, it clearly is an outstanding important accounting issue.

***ISSUE 6 – Definition of Insurance contract***

***Proposed by: CEIOPS***

***No interpretation in the area of Insurance contracts has been issued after publication of IFRS 4***

CEIOPS refers to the difficulties which companies face in practice when applying the definition of an insurance contract under IFRS 4 and specifically the difficulties in interpreting what is meant by "significant additional benefits" and "scenarios that lack commercial substance".

***ISSUE 7***

***Guidance on substance over form: Linked, bundled and structured transactions***

***Proposed by: Finnish Accounting Board***

***The issue has been dealt with by the IASB in 2002, then referred to IFRIC with no outcome***

One of the most difficult areas in accounting (including IFRS) is structured transactions of any kind. In some cases e.g. financial leases there is specific guidance (IAS 17), but often e.g. in business combinations this is not available and one has to refer to the underlying principle of substance over form. Therefore preparers, auditors and regulators usually go back to their traditional national ways of interpreting and applying the standards, which can vary across jurisdictions. The issue is therefore crucial for consistent application of IFRS and should therefore be taken on board by IFRIC. It had initially been discussed at the IASB in October 2002, and referred to IFRIC but did not result in any solutions.

#### ***ISSUE 8***

##### ***Tax Amortization Benefit (TAB) in asset valuations***

***Proposed by: Finnish Accounting Board***

***Not already dealt with by IASB/IFRIC***

The issue is whether or not to include tax amortisation benefits in the purchase price allocation (ppa) in a business combination. There is no specific guidance (e.g. in IFRS 3 or IAS 38) of which components should be included in the fair value of intangible assets when using the appropriate valuation techniques to which reference has been made. The only guidance found is non authoritative and comes from the US GAAP regime.

#### ***ISSUE 9***

##### ***Recognition of a deferred tax asset for the carryforward of unused tax losses when an entity has a history of recent losses***

***Proposed by: The Swedish Financial Accounting Standards Council***

***Not already dealt with by IASB/IFRIC***

The issue is whether, under IAS 12 (paras 34 vs. 35), a company is allowed to recognise deferred tax assets. For it to be able to do there has to be a probability of future taxable profits. In the case of a company having a history of losses there needs to be sufficient taxable temporary differences or "existing other evidence" that the company would be able to show future taxable profits. The key question is the meaning of "probability" of future taxable profits compared to the notion of "existing other evidence" and whether the two notions are of equal weight.

## ***B. Detailed description of Issues Proposed***

### ***ISSUE 1***

#### ***IFRIC 9 Reassessment of Embedded Derivatives***

***Proposed by: EFRAG***

The November 2005 IFRIC Update reported that the IFRIC had decided not to expand the scope of IFRIC 9 Reassessments of Embedded Derivatives to cover whether reassessment of embedded derivatives in contracts held by the acquiree was required and a related issue whether entities could redesignate items in and out of the at fair value through profit or loss category in the group accounts on the date of the business combination. IFRIC decided instead to refer these issues to the IFRIC Agenda Committee in order that a recommendation might be developed that would consider among other things whether the issues are likely to be addressed by the IASB in its current Business Combinations project.

We note that paragraph 6 of the exposure draft that FASB has recently issued on “The fair value option for financial assets and financial liabilities” affirms that an entity may elect to use the fair value attribute for initial and subsequent measurement for a financial asset or financial liability on the date that a financial asset or financial liability is initially recognized or upon an event that gives rise to new-basis accounting at fair value examples being business combinations and significant modifications of debt.

Furthermore, the FASB exposure draft in paragraph 9 states that in “business combinations the acquiring entity’s decision whether to elect the fair value option for specific assets acquired and liabilities assumed or incurred is not affected by any previous election of the fair value option by the entity that was acquired in the business combination. If a subsidiary is newly consolidated, the consolidation represents the initial recognition of those assets and liabilities by the consolidated reporting entity. Upon consolidation (or reconsolidation) of a subsidiary or a variable interest entity (as discussed in FASB Interpretation No. 46 (revised December 2003), Consolidation of Variable Interest Entities), the fair value option election is permitted for such newly consolidated assets and liabilities for purposes of reporting by the consolidated entity”.

A similar conclusion has been reached under the US GAAP in relation to hedging relationships. Thus, DIG E15 concludes that the purchase business combination results in a new inception date for the combined entity for hedging relationships entered into by the acquiree prior to the business combination that remain ongoing at the date of the business combination.

However, unlike US GAAP, the IFRS literature does not directly address such issues. As a result, although some commentators may come to an analogous conclusion under IFRS as under US GAAP—i.e. that a business combination is a triggering event for a reassessment and a reclassification, based on the requirement in IFRS 3 Business Combinations to account for acquired assets and liabilities at fair value at the date of the business combination—others are we understand arguing that IFRS is unclear on this matter.

Some of those arguing that IFRS is unclear are pointing to the Exposure Draft of Proposed Amendments IFRS 3 Business Combinations, which included guidance on classification of leases acquired as a result of business combination stating in paragraph

38 that “In accordance with IAS 17 Leases, a lease of the acquiree (regardless of whether the acquiree is the lessee or lessor) retains the lease classification determined by the acquiree at the lease inception, unless the provisions of a lease are modified as a result of the business combination in a way that would require the acquirer to consider the revised agreement a new lease agreement in accordance with paragraph 13 of IAS 17. In that circumstance, the acquirer would classify the new lease according to the criteria set out in IAS 17 on the basis of the conditions of the modified lease.” Although it could be argued whether it is appropriate to apply this guidance by analogy, this guidance might suggest a conclusion that a business combination is not a triggering event for a reassessment and a reclassification of financial instruments acquired in a business combination.

It is our understanding that this difference of view as to what the underlying principle is on a business combination is currently leading to differences in practice, and we suspect that in some circumstances those differences could have a material effect on the financial statements. Given that the issue has widespread and practical relevance, we would like to encourage IFRIC to issue an interpretation to clarify what the underlying principle is in the near future rather than wait until Phase II is complete. It is also our understanding that, the relevant IFRS requirements underlying the issue are unaffected by Phase II. Therefore, it seems feasible to clarify the principle on reassessment and reclassification in business combinations without waiting until completion of the project.

## ***ISSUE 2***

### ***Waste of Electrical and Electronic Equipment (WEEE)***

***Proposed by: UNICE***

#### 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. The issue with respect to 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. For new waste this assessment from IFRIC can be challenged. In various 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. As yet it is difficult to conclude whether the lack of local guidance in some countries, or possible differences between local guidance in other countries with similar legal structures 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 this is not the case, e.g. in Germany and in the Netherlands, the risk of inconsistencies arises. Some may argue that the issue of new waste is a local issue that has to be addressed in each Member State on the basis of the legislation that is introduced to implement the Directive. However, that reasoning disregards the fact that similar legal structures have been enacted by Member States which require that the same accounting conclusions are drawn with respect to these structures.

### 3. Two alternative approaches

Different models for the decommissioning of new waste can be enacted by Member States. The responsibility can be put on individual producers or the law can provide the possibility for producers to join collective arrangements for the decommissioning of WEEE. In the last case producers may be able transfer their responsibility to the collective scheme (in full or to some extent). The funding of the collective scheme can either be based on a direct attribution model (the producers share of clearly identifiable WEEE determines the obligation – referred to as an advance financing model in the German AIC 2) or on a pay-as-you-go model (the producers share of the total quantity of equipment put on the market during the measurement period determines the obligation). In a pay-as-you-go model it can be expected that the producers are required to provide security for their future obligations either individually or collectively.

Looking at the various models that are possible the question arises when the accounting for new waste can follow the principles of IFRIC 6 and how the requirements of IAS 37 need to be applied in cases that are not addressed by IFRIC 6. The German AIC 2 deals with the various models that are likely to occur and comes to accounting conclusions. However, it is not an interpretation of IFRS and there is no mechanism in place that ensures that others (auditors, preparers in other countries and other national standard setters) come to the same conclusions in cases where the legal position is the same.

#### **ISSUE 3**

##### ***Deemed cost of a subsidiary in first time application***

***Proposed by: OIC - Organismo Italiano di Contabilità***

#### **The issue:**

The IFRS 1, paragraphs 16-18, specifically permit, under certain conditions, a IFRS first-time adopter to elect to measure, at fair value or previous GAAP revaluation as deemed cost, an item of property, plant and equipment, investment property or intangible assets. This Standard, however, does not specifically address a similar exemption for recalculating the initial cost of an investment at time of transition to IFRS.

As a consequence, in accordance with the requirements of IAS 27, in the parent company separate financial statements the investments in subsidiaries, associated entities and joint ventures, which were accounted for with the equity method under previous GAAP, should be measured, either at cost, or at fair value in accordance with IAS 39 (unless these investments are defined as held for sale). It is to be noted that paragraph 4 of IAS 27 provides a definition of the “cost method”, but then it does not address any specific exemption or alternative for the case where there is little (or none) mean to retroactively determine the value of the acquisition consideration.

### **Current practice:**

The requirements of IFRS 1 and IAS 27 are particularly burdensome in those jurisdiction where the parent entity separate financial statements are prescribed to be IFRS compliant and for which the measurement at fair value of their investments in subsidiaries results unreasonably costly or very difficult to be applied. The reconstruction of the IAS 27 compliant original consideration paid may result severely troublesome for those entities which have historically measured their investments with the “equity method” as required by previous GAAP.

Several factors - or any combination of them - contribute to such a difficulty. Among these, we may mention: the acquisition of the entity may have occurred in a far past year; allocation of dividends paid between pre-acquisition and post-acquisition profits and their treatment under local standards has been treated differently than IFRSs; the acquisition may have been made in steps at various times over the years; the entity may have acquired the control of the subsidiary subsequent to an initial investment; the entity could have directly formed its subsidiary, as well as it could have been acquired in the market through a business combination transaction.

Furthermore, the resulting retroactively reconstructed cost is likely to result in an unrealistic amount considerably lower than the fair value of the investment, particularly when the acquisition took place many years before. As a consequence, the fairness of the reconstructed cost as well as the actual utility of the information to the reader can be arguable.

Finally, it appears unlikely that the cost of such remeasurement is fairly balanced by the benefit of the information so obtained.

### **Reasons for the IFRIC to address the issue:**

We are aware that the issue is included un the Board agenda and that several options are being under study, including a possible revision of both IFRS 1 and IAS 27. However, because of the time necessary for resolving the controversial and complex implications of the issue when compared to its relevance, a solution is not likely to be ready in the due time, so that entities might be tempted to adopt an approach which may subsequently demonstrate not to be IFRS compliant. Any subjective interpretation made by the preparers of financial reports during this time may have significant consequences.

Accordingly, it would be necessary a transitional provision of a reasonable method for calculating the deemed cost of the investment in the first time application of IFRSs.

Absent a similar exemption, the current standards may cause additional costs to the preparers for restating their prior period non-compliant separate accounts, as well as possible fluctuations in the stock markets and different opinions by the financial analysts. We believe that in the wait for a revised version of relevant requirements an IFRIC interpretation as to the possibility of an extension of current exemptions is appropriate.

#### ***ISSUE 4***

***IAS 24 disclosure of post-employment benefit***

***Proposed by: EECS/CESR-Fin***

Paragraph 16 of IAS 24 outlines the disclosure requirements for key management personnel's compensation.

Specifically, it requires aggregate disclosures for each of the following categories:

- a) Short-term employee benefits;
- b) Post-employment benefits;
- c) Other long-term benefits;
- d) Termination benefits; and
- e) Share-based payment.

The issue arising is what the post-employment benefit disclosure should consist of?

Some companies may decide to include an amount based on their Income Statement charge or based on the employer pension contribution for key management. However, there are various amounts relating to employee benefits, and more specifically defined benefit schemes, appearing in the Income Statement, distributed over such captions as current service cost, interest cost, expected return of plan assets, past service cost etc. Furthermore, IAS 19, as amended in December 2004, allows a number of choices for accounting for actuarial gains and losses. In effect, depending on their accounting policy, an entity can, inter alia, recognize the full actuarial gain or loss in the Income Statement, spread the full actuarial gain or loss over the average remaining service lives of employees in the Income Statement or some other faster systematic method as deemed appropriate, or restrict the amount recognised to an amount in excess of the "corridor" spread in a manner similar to the aforementioned. The amendment to IAS 19 now allows another option whereby the actuarial gains and losses can be recognised immediately, outside the Income Statement in the Statement of Recognised Income and Expense (SRIE).

How should the "post-employment benefit" element of key management consideration be calculated? Should it be influenced by the accounting policy choices made in how to account for defined benefit plans under IAS 19? If so, how should the amount be derived? If not, what amount should be disclosed?

In the absence of specific guidance by the IASB, it is difficult for CESR members to take a definite decision and not permit an entity from calculating the amount as they see fit, provided it seems reasonable, is consistently applied and the method used is disclosed.

A possible solution would be that the amount should be the actuarially determined increase during the year in the value of the pension promise earned by the key management. In practice this will be a difficult and potentially costly figure to derive and a pro-rating exercise may be appropriate. For example the amount disclosed could be a portion of the current service cost plus the actuarial gain/loss on the pension liability based on the key management's pensionable salary compared to total pensionable salary.

**ISSUE 5**

***Common control transactions***

***Proposed by: Dutch Accounting Standards Board***

## 1. ISSUE DESCRIPTION

IFRS 3 *Business Combinations* does not apply to business combinations involving entities or businesses under common control (IFRS 3.3). IFRS 3.10-13 and Appendix A provide additional guidance as to the extent of this scope exclusion:

- For the scope exclusion to apply, all of the combining entities or businesses must ultimately be controlled by the same party or parties, both before and after the business combination.
- That control (both before and after the combination) is not transitory.
- The common control exclusion includes transactions between entities within a group. However, common control can also be exercised by an individual or a group of individuals as a result of contractual arrangements. The scope exclusion does not require that combining entities are included in the same consolidated financial statements.
- The extent of minority interest in each of the combining entities before and after the business combination is not relevant to determining whether the common control exclusion applies. That is, the common control exclusion applies even if the business combination results in a change in minority interest in a partially owned subsidiary.
- The fact that one of the combining entities is a subsidiary that has been excluded from consolidation is not relevant to determining whether the common control exclusion applies.

In respect of business combinations between entities under common control, two distinct issues can be identified:

1. Issues in respect of the boundaries of the scope exclusion in IFRS 3.
2. The bigger issue: how should business combinations between entities under common control be accounted for?

Next to business combinations, other transactions between entities under common control pose reporting questions similar to issue 2. For example, how should spin-offs, split-offs or de-mergers be accounted for if the spun off or de-merged entities continue to be controlled by the same party or group of parties?

### 1.1. Boundaries of the scope exclusion in IFRS 3

The boundaries of the scope exclusion are clarified in the guidance described above (IFRS 3.10-13 and A.3). The conditions that common control exists ‘both before and after’ and ‘is not transitory’ are anti-abuse measures that were included in IFRS 3 to deal with so-called “grooming” transactions, i.e. transactions that are structured (“dressed up”) to look as though they are a business combination under common control but in fact represent a genuine substantive business combination with unrelated parties (see also IFRS 3.BC28).

Questions in respect of the boundaries of the common control scope exclusion may continue to arise in future, depending on the fact pattern and the particular structure of the business combination. For example, a specific issue was recently brought to IFRIC regarding the meaning of ‘is not transitory’. This issue was not taken on the IFRIC agenda (see rejection decision described in section 3.1 below).

## 1.2. How to account for transactions under common control?

There are many forms and variations of common control transaction; two different examples may illustrate this (both business combinations):

- (a) P is the direct parent company of 100% subsidiaries A and B. If P restructures its group such that A holds all the shares in B, this would be an intra-group transaction without effect on P's consolidated financial statements. If A prepares own financial statements under IFRS, the question is how the 'business combination' with B should be accounted for in A's financial statements, as it involves the acquisition of an entity under common control.
- (b) The X-family is the majority shareholder in two groups of companies, the A group (51%) and the B group (65%); X controls both groups. Although A and B are under common control, they prepare separate consolidated financial statements. If the A group acquires subsidiary C (a business) from the B group, this would be a business combination between entities under common control, outside the scope of IFRS 3. As such, A would not be required to apply the purchase method when accounting for the acquisition of C.

In examples as these, the key question is the basis of accounting to be used. Basically, there are two alternatives:

- Record the transaction at fair value. For a business combination between entities under common control, this would involve applying the purchase method as described in IFRS 3 by analogy. For a spin-off or de-merger under common control this would involve remeasurement in the financial statements of the spun off or de-merged entity.
- Use pre-transaction book values of the parent company, carried over into the post-transaction financial statements of the entity involved<sup>1</sup>. For a business combination, the accounting would be similar to applying the pooling of interests method. The financial statements of a spun off or de-merged entity would not show a remeasurement to fair value, but a carryover of book values.

The basis of accounting to be used for common control transactions is unresolved in IFRS. This may be due to unresolved conceptual issues, i.e. whether an 'entity' concept or a 'proprietary' concept should be used<sup>2</sup>. The current *Framework* is not clear as to which of these accounting concepts (or mix thereof) should be adopted. In addition, the hierarchy in IAS 8 could point to using the IFRS 3/fair value approach by analogy, but also to the use of book values as this is generally mandated under US GAAP for common control transactions.

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<sup>1</sup> Complexities arise in the book value model when the common control transaction involves cash consideration different from the book values used. These are not further discussed for the sake of simplicity.

<sup>2</sup> Under the 'entity' concept, the reporting entity is distinct from its owners. In simple terms, this concept implies that transactions between the entity and its owners (including common control transactions) should not be accounted for differently than transactions with unrelated parties. This concept would point to using fair values. Under the 'proprietary' concept, the perspective of financial reporting is that of the owners/shareholders; for reporting purposes, the entity is considered as an extension of its owners/shareholders. This concept would point to using book values. The accounting concept is currently unresolved, although the IASB has made several decisions that can be regarded as consistent with the entity model.

## 2. CURRENT PRACTICE

We have not researched to what extent the book value or fair value method are being used in practice for transactions between entities under common control. However, both methods are used in practice. It also seems that the book value method is used more frequently, in particular in respect of group reorganisations.

In practice, it seems that the following approaches are followed:

1. Depending on the type of transaction and the related fact pattern, a transaction between entities under common control is characterised as either:
  - A non-substantive legal reorganisation, where the (relative) rights of the parent company or ultimate shareholders are not affected by the transaction. It is then argued that there are no grounds for a new basis of accounting and that book values are the appropriate basis for recording such transaction. Example (a) in section 1 could fit this description.
  - A substantive transaction affecting the (relative) ownership interests of shareholders or minority interests. It is then argued that the substantive nature of the transaction should be reflected by using a new basis of accounting, i.e. fair value is the appropriate basis for recording the transaction. Example (b) in section 1 could fit this description.
2. The basis of accounting to be used for transactions between entities under common control is an element of accounting policy choice. I.e., the entity makes a policy election to account for such transactions either as fair value transactions or book value/cost transactions.

## 3. CONSIDERATIONS WHETHER OR NOT TO REQUEST INTERPRETATION BY IFRIC

### 3.1 Relation with IASB projects and IFRIC agenda decisions

#### *IASB*

Common control transactions have been on the IASB agenda in the past. It was included as one of the topics to be addressed in phase II of the Business Combinations project. However, phase II did not address the issue but rather focused on the application of the purchase method and related issues.

Common control transactions as such are not on the current IASB agenda. Entities under common control were mentioned in the initial discussion on phase D (Reporting Entity) in the Conceptual Framework project. The Board has decided that discussions in this area should focus on the boundaries of the reporting entity and the related concept of control. The relevant text in IASB Update of December 2005 is as follows:

“The Board began its deliberations on Phase D, Reporting Entity. It discussed preliminary staff research on the reporting entity concept and reached the following conclusions:

- ...
- The staff should investigate whether the boundaries of a group reporting entity should be based on a broader concept of control, for example, a concept that might encompass entities under common control.”

It is currently not clear whether this research may lead to future guidance on how to account for transactions between entities under common control.

### *IFRIC*

In 2002 the IFRIC considered staff proposals on the concepts that underlie accounting for transactions with owners and common control transactions. The concepts discussed the differences between an entity and a proprietary outlook toward the various transactions with owners. The IFRIC discussed these concepts and principles in order (a) to determine whether it could discern an approach for dealing with transactions with owners and common control transactions, and (b) to provide input into the IASB's Accounting Concepts project dealing with refinements of the elements literature (IFRIC Update, August 2002). No detailed paper or further discussion was published by IFRIC.

#### *IFRIC agenda decision on 'Transitory' common control (March 2006)*

In March 2006, the IFRIC considered a specific issue regarding whether a reorganisation involving the formation of a new entity to facilitate the sale of part of an organisation is a business combination within the scope of IFRS 3. It was suggested to the IFRIC that, because control of the new entity is transitory, a combination involving that newly formed entity would be within the scope of IFRS 3. The IFRIC decided not to add this topic to its agenda. In rejecting the topic, the IFRIC noted that the question of whether the entities or businesses are under common control applies to the combining entities that existed before the combination, excluding the newly formed entity.

The agenda decision also included a broader statement on addressing common control: "The IFRIC also considered a request for guidance on how to apply IFRS 3 to reorganisations in which control remains within the original group. The IFRIC decided not to add this topic to the agenda, since it was unlikely that it would reach agreement in a reasonable period, in the light of existing diversity in practice and the explicit exclusion of common control transactions from the scope of IFRS 3."

In other words, the issue was considered 'too big' for IFRIC, also in view of the explicit scope exclusion in IFRS 3.

### **3.2 Does the issue have widespread and practical relevance?**

In respect of issue 1 (boundaries of the scope exclusion in IFRS 3) – No.

Although any issue in respect of the scope exclusion will often have a significant effect on the financial statements, the key boundary-issues seem to have been addressed in the guidance in IFRS 3.10-13. Certain interpretation questions may continue to arise in practice (see for example the IFRIC agenda decision described in section 3.1 above) but the exact nature will be difficult to predict and dependent on the fact pattern involved. As far as we can observe, these interpretation issues are not currently widespread.

In respect of issue 2 (how to account for transactions under common control) – Yes.

Business combinations and other transactions between entities under common control occur regularly and in many jurisdictions.

- These transactions often occur as part of group reorganisations. These reorganisations will not affect the group consolidated financial statements under IFRS, although minority interests may be affected, but the (consolidated) IFRS financial statements of the combining group entities can be significantly affected.

- Such transactions may also occur where one of the combining entities' shares are listed but control is exercised by another entity, individual or group of individuals outside the consolidated financial statements. This is particularly the case in jurisdictions where a (group of) individual(s), e.g. a wealthy family, owns a controlling share in different reporting entities.
- The accounting method followed (either fair value or book value/cost) will often have a significant effect on the financial statements of the reporting entities involved.

### **3.3 Does the issue involve significantly divergent interpretations (either emerging or already existing in practice)?**

In respect of issue 1 – No.

In respect of issue 2 – The accounting for transactions under common control is not addressed in IFRS. As such, the issue cannot technically be subject to divergent interpretations of IFRS. Nevertheless there is significant diversity in practice (see description of current practice in section 2 and the 'broader' IFRIC statement in section 3.1).

Because of the fundamental nature of the issue, the fact that it is not addressed in IFRS and the apparent diversity in practice, the issue probably does not lend itself for interpretation by IFRIC. If it is to be addressed, it seems more appropriate to do this at the IASB level.

## ***ISSUE 6***

### ***IFRS 4 (Definition of 'Insurance Contract')***

***Proposed by: CEIOPS***

#### **1. GENERAL CONSIDERATIONS**

The application of IFRS in the insurance sector has many limitations due to the fact that IFRS4, the insurance contracts standard, is just an interim solution and that the definition of a complete and coherent standard is currently being developed.

Since IFRS 4 is a temporary solution, it gives an insurer the possibility of using different options. Examples of these can be found within the option to use a current discount rate for the valuation of some designated liabilities without clearly defining guidelines to this fair value oriented approach, the requirement of performing the liability adequacy test without clear orientation regarding risk-aggregation principles and the possibility to use shadow accounting which is an accounting model not expected to be in place in phase II of the IASB's Insurance Contract project.

Nevertheless, once phase II will be finalised, the above options will be restricted. At this stage, since the insurance project phase II is being developed, it is pointless to try to formulate guidelines on existing accounting methodologies as these will be replaced by phase II.

It is also worth noting that despite the options available under IFRS 4, it is a fact that the application of common IFRS has a positive effect in the general environment of financial reporting convergence between banking and insurance, by diminishing the level of differences previously presented within sectoral accounting rules and by increasing transparency and consistency of reporting across the EU.

## 2. DEFINITION OF INSURANCE CONTRACT

Some concerns have however been raised regarding different interpretations of the definition of ‘insurance contract’.

The main issues arise under Appendix B, paragraphs B22-B28, which discuss the assessment of whether insurance risk is significant. Accordingly, an insurance risk is significant if, and only if, an insured event could cause an insurer to pay significant additional benefits in any scenario, excluding scenarios that lack commercial substance.

The additional benefits refer to the amounts that exceed those that would be payable if no insured event occurred, and these amounts shall refer to the net cash flows arising from the contract, including claims handling and claims assessment costs.

Furthermore, paragraph B23 stipulates that an insurance risk may be significant even if the insured event is extremely unlikely or if the expected present value of contingent cash flows is a small proportion of the expected present value of all remaining contractual cash flows. The determination of significance is performed on an individual contract basis (paragraph B25).

The application of this principles-based definition heavily depends on the interpretation of the concepts of “significant additional benefits” and “scenarios that lack commercial substance”.

The examples provided in the implementation guidance of IFRS4, together with the practice guidelines developed by the International Actuarial Association<sup>3</sup> provide some clarification on these concepts, contributing to a more consistent application without defining rules-based thresholds.

Nevertheless, considering the growing complexity of insurance products, some additional guidelines could help a more consistent application of these concepts.

However, we believe that we should wait for a period of at least two years since the introduction of IFRS before we can assess fully the implications mentioned above. This is because we have to wait for a full reporting cycle so that we can have a clear idea how IFRS 4 has been applied by firms.

### ***ISSUE 7***

***Guidance on substance over form: Linked, bundled and structured transactions***

***Proposed by: Finnish Accounting Board***

#### **The issue:**

The substance over form principle, long established in accounting theory and practice, is also fundamental to the application of a principles-based set of accounting standards such as IFRS. It provides the justification for accounting for structured transactions, or sets of transactions, according to their underlying economic nature instead of their legal form. In some cases, e.g. financial leasing, we have specific standards that in effect specify how to apply the substance over form principle to commonly encountered transactions. For less common transactions there can obviously be no specific standards.

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<sup>3</sup> IASP 3 – Classification of contracts under IFRS (2005)

In cases where there is no specific standard that governs the application of the substance over form principle, we are usually dealing with either linked or bundled transactions. For linked or interdependent transactions, we may face the question of whether the transactions or some subset of them should be treated as a whole, and accounted for as if they were a single transaction. For bundled transactions, the question may be whether to account separately for some or all of the components of what is formally one single contract. The issue can arise at two levels, i.e. when determining which IFRS that is applicable, and when determining how to interpret and apply a particular IFRS. In some cases, doubt arises as to which level is the appropriate one.

Particularly troublesome cases arise, for instance in business combinations, when a series of transactions all individually make economic sense when viewed in isolation, but together accomplish a clearly intended purpose. When individually accounted for, the result on the financial statements may be materially different than if they were accounted for as a single transaction.

There would be a need for guidance from the IASB/IFRIC on the criteria to apply when deciding whether to bypass the legal form of transactions and account for their economic substance, and about the relative weight to be accorded to different factors.

The issue was discussed at the IASB Board Meeting 23-25 October 2002, where it was referred to IFRIC. IFRIC has a short paper on linkage of transactions dated 1 March 2003.

### **Current practice:**

As there is no authoritative guidance on the application of the substance over form principle, preparers, auditors and regulators are in effect forced to turn to their respective national traditions of legal interpretation and application of accounting standards. These differ greatly across the countries where IFRS is applied, and the resulting application of IFRS's consequently also seems to differ widely. In particular, in some countries there is a very strong presumption that the legal form of a transaction or contract should determine the accounting treatment, unless evidence of something equivalent to fraud is present. Interpreting the substance of a transaction in a different manner than the legal form chosen by the preparer is seen as prejudicing the legitimate right of parties to freely choose between different contractual arrangements. In other countries, with different traditions of accounting jurisprudence, a much greater weight is given to determining the economic nature of a set of transactions using in effect a clean slate approach, without similarly great weight being given to legal forms of the transactions.

### **Reasons for the IFRIC to address the issue:**

Reasonably consistent application of the substance over form principle across countries and cases is crucial if a principles-based standards framework like IFRS is to result in consistent and comparable financial statements. In the absence of guidance, widely different national traditions of interpreting laws and standards inevitably lead to the substance over form principle being applied in very different manners across Europe. This clearly seems to be the present case.

The issue is also important since in practice a large percentage of the really difficult cases of interpreting and applying IFRS seem to boil down to a question of how to interpret

substance over form. On the subject of substance over form, guidance in the form of published professional or academic literature is also quite surprisingly scarce.

Substantive guidance on how to apply the substance over form principle from IASB/IFRIC would hopefully serve to some extent in stemming the flood of requests for detailed judgments on how to properly account for individual, specific cases. This would help preserve the principles based character of IFRS, and prevent the slide towards a rules based accounting environment.

In a sense the project is already on the IFRIC/IASB agenda as per the IASB Board Meeting 23-25 October 2002, but nothing more substantial than a memo as per 1 March 2003 has yet emerged.

### ***ISSUE 8***

#### ***Tax Amortization Benefit (TAB) in asset valuations***

***Proposed by: Finnish Accounting Board***

#### **The issue:**

#### **Tax Amortization Benefit (TAB) in asset valuations**

In a business combination, the purchase price is to be allocated to acquired assets and liabilities. Allocation has to be made in accordance with IFRS 3 guidelines, and when intangible assets are acquired in a business combination, IAS 38 gives additional guidelines. Both the IFRS 3 and IAS 38 refer to valuation techniques that are to be used in the purchase price allocation. IFRS 3 nor IAS 38 do not define precisely how the asset valuations should be performed and what components should be included in the fair value of intangible assets when using the discounted cash flow techniques mentioned by IAS 38.41 and IFRS 3 Appendix B17.

The lack of specific guidance on the issue has led to a situation where companies include in the asset valuations, which are used for the purpose of allocating the purchase price to identifiable assets, different components regarding the tax benefits (Tax Amortization Benefit, TAB).

#### **The rationale of the opinion to include TAB in the asset valuations for the purpose of purchase price allocation:**

Fair value of each item acquired in a business combination must be defined separately as if the assets had been acquired separately from the other assets acquired. This means that the structure of the deal, share deal or asset deal, should not effect the fair value of assets acquired. In an asset deal, the acquirer receives a tax benefit, as the tax basis of the acquired assets is the same as the acquisition price of the asset. Therefore the tax benefit should also be included in the fair value of asset also when the assets are acquired by the share deal, in spite of the non-tax-deductibility of the difference between the book value and the fair value of the assets. Tax amortization benefit (TAB) should be a component of incoming cash flows.

TAB is employed in intangible asset valuations for the purposes of valuations performed in accordance with SFAS 141 Business Combinations. Guidance on TAB is found in the AICPA IPR&D Practice Aid. The AICPA IPR&D Practice Aid is not an authoritative

source of US GAAP. However, it has gained importance as it reflects industry practice in the US. TAB is not discussed in SFAS 141 or SFAS 142.

**The effects to consolidated accounts of employing TAB versus not employing TAB in asset valuations used in purchase price allocations are:**

- The profits and equity of an entity are smaller if the TAB is included in the fair value. The reason for this:
  - TAB increases the value of amortizable assets in consolidated accounts → more amortization, less profits. This is partly offset by the reversal of deferred tax liability (credit = income) which was initially recognized on the allocated asset amounts (contra account was in goodwill).
- TAB decreases the amount of residual value of the purchase price to be recognized as goodwill. This is partly offset by the deferred tax liability book entry that is recognised on the allocated amounts (db goodwill cr deferred tax liability).
- The difference in accumulated profits and equity will be released when the shares of acquired company will be sold or an impairment loss recorded on goodwill. The effect of different methods remains as long as the business is based on going concern principle and no impairment loss is recorded on the goodwill acquired in the business combination.

**IFRS standards and paragraphs that give guidance on the issue:**

According to IFRS 3.36 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.

IFRS 3.37: The acquirer shall recognise separately the acquiree's identifiable assets, liabilities and contingent liabilities at the acquisition date only if its fair value can be recognized reliably and the other criteria of paragraph IFRS 3.37 a, b and c are met.

IFRS 3 Appendix B17: Some of the above guidance requires fair values to be estimated using present value techniques. If the guidance for a particular item does not refer to the use of present value techniques, such techniques may be used in estimating the fair value of that item.

IAS 12.19 (Income taxes): The cost of business combination is allocated by recognising the identifiable assets acquired and liabilities assumed at their fair values at the acquisition date. For example, when carrying amount of an asset is increased to fair value but the tax base of the asset remains at cost to the previous owner, a taxable temporary difference arises which results in a deferred tax liability. The resulting deferred tax liability affects goodwill.

IAS 38.41\_ Entities that are regularly involved in the purchase and sale of unique intangible assets may have developed techniques for estimating their fair values indirectly. These techniques may be used for initial measurement of an intangible asset acquired in a business combination if their objective is to estimate fair value and if they

reflect current transaction and practices in the industry to which the asset belongs. The techniques include, when appropriate:

- (a) applying multiples reflecting current market transactions to indicators that drive the profitability of the asset (such as revenue, market shares and operating profit) or to the royalty stream that could be obtained from licensing the intangible asset to another party in an arm's length transaction ( as in the "relief from royalty" approach); or
- (b) discounting estimated future net cash flows from the asset.

IAS 38.33:... The fair value of an intangible asset reflects market expectations about the probability that the future economic benefits embodied in the assets will flow to the entity. In other words, the effect of probability is reflected in the fair value measurement of the intangible assets. Therefore, the probability recognition criterion in paragraph 21 (a) is always considered to be satisfied for intangible assets acquired in business combinations.

### **Current practice:**

Current practice is disordered. Experienced auditors in Europe have estimated that perhaps 20% of companies take the TAB into account when possible, and 80% do not. The situation apparently varies quite a lot between different countries.

### **Reasons for the IFRIC to address the issue:**

The issue does not seem to be directly related to an IASB project that would be nearing completion. There is widespread variation in practice, with preparers and auditors reaching for guidance from AICPA pronouncements in the absence of more authoritative sources. The effects of the varying treatment of this issue are in many cases significant with respect to reported earnings.

### ***ISSUE 9***

***Recognition of a deferred tax asset for the carryforward of unused tax losses when an entity has a history of recent losses***

***Proposed by: The Swedish Financial Accounting Standards Council***

### **The issue:**

According to IAS 12, para. 34, "A deferred tax asset shall be recognised for the carryforward of unused tax losses and unused tax credits to the extent that it is probable that future taxable profit will be available against which the unused tax losses and unused tax credits can be utilised".

However, according to para. 35, "the existence of unused tax losses is strong evidence that future taxable profit may not be available. Therefore, when an entity has a history of recent losses, the entity recognises a deferred tax asset arising from unused tax losses or tax credits only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity".

It is not clear from the standard which meaning the notion of “probable” has. One may argue that there is a tension between “probable” and “convincing other evidence”. The latter notion seems to be more demanding than what is often meant by “probable”.

The issue is how deferred tax assets should be accounted for and how **convincing other evidence** should be interpreted when a company has a history of recent losses and considers the accounting for deferred tax assets.

### **Current practice:**

Our understanding is that the accounting treatment in this context is divergent and widespread. Some alternative accounting practices are:

- Deferred tax assets are recognized only when an entity has sufficient taxable temporary differences relating to the same taxation authority and the same taxable entity, which will result in taxable amounts against which the unused tax losses can be utilised before they expire (see IAS 12 para 36 a). Thus in many cases, because of the history of recent losses, no convincing evidence is deemed to be there to justify recognition of deferred tax assets.
- Deferred tax assets are recognized only when the unused tax losses did result from identifiable causes which are unlikely to recur (see IAS 12 para 36 c). “Convincing evidence” is thus linked to the existence of “identifiable causes”.
- Deferred tax assets are recognized when there are specific tax planning opportunities (see IAS 12 para 36 d).
- Deferred tax assets are recognized only when taxable profits are expected to be generated in the near future say the next 2- 3 years (even if the tax losses can be utilised indefinitely). The expected taxable profits are based on reasonable and supportable assumptions that represent management’s best estimate of economic conditions that will exist in the next 2-3 years. Others apply a 5 years horizon. Thus the planning horizon is restricted to reflect what is deemed to be “convincing”.
- Deferred tax assets are recognized when taxable losses are expected in the near future say the next 2-3 years but taxable profits are expected to be generated thereafter. The expected taxable profits are based on reasonable and supportable assumptions that represent management’s best estimate of economic conditions that will exist in the future. Thus a long term view is taken on the expectations of future taxable profits.

### **Reasons for the IFRIC to address the issue:**

- We believe that this issue has widespread and practical relevance.
- We believe that the issue involves significantly divergent interpretations.
- Our understanding is that this issue has not been addressed in the short term convergence project: income taxes.

According to FAS109, Basis for conclusions para. 103 “The Board believes that the more likely than not criterion required by this statement is capable of appropriately dealing with all forms of negative evidence, including cumulative losses in recent years. That

criterion requires positive evidence of sufficient quality and quantity to counteract negative evidence in order to support a conclusion that, based on the weight of *all* available evidence, a valuation allowance is not needed. A cumulative loss in recent years is a significant piece of negative evidence that is difficult to overcome. For that reason, the Board concluded that a more restrictive criterion such as assured beyond a reasonable doubt is not necessary.”

Furthermore it should be noted that according to FAS 109, Basis for conclusions para. 102 “The Board is also concerned about the effect on earnings when an enterprise moves into or out of a three-year cumulative loss status. When an enterprise moves into a three-year cumulative loss status, the assured beyond a reasonable doubt criterion would (a) prohibit recognition of a tax benefit for the current year loss and (b) require recognition of a valuation allowance for deferred tax assets originally recognized in prior years. In those circumstances, deferred tax expense from elimination of the deferred tax asset would be added to a pretax loss to produce a larger net loss. Similarly, when an enterprise moves out of a three-year cumulative loss status, the more likely than not criterion might remove the need for a valuation allowance. In those circumstances, a deferred tax benefit from reinstatement of the deferred tax asset would be added to pretax income to produce larger net income.”

As mentioned above IAS 12 is different. Deferred tax assets should be recognized only to the extent that the entity has sufficient taxable temporary differences or there is convincing other evidence that sufficient taxable profit will be available against which the unused tax losses or unused tax credits can be utilised by the entity.

Based on the above, we believe that it would be appropriate for IFRIC to issue **principle** based guidance on the manner in which **convincing other evidence** should be interpreted.