RSM International
global excellence in audit, tax & consulting

June 2010
Issue 4

RSM Reporting

Welcome from the Editor
Marco Mongiello

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

In this issue:

Section 1: News and updates

Marco Mongiello on a new definition of assets

Bob Dohrer on the IASC Foundation's proposed IFRS Taxonomy 2010

Section 2: The point of view of ...

...Mike Wells who discusses the benefits of global financial reporting standards

...Nicolas Perenchio on the impacts of the revised IFRS 3 and IAS 27

...Marco Marcellan & Jane Meade on Reporting Challenges Posed by Carbon Trading Schemes

Section 3: Top Ten Topics in IFRS
by *Stefano Bianchi*

Given the increasing pace of developments in global accounting, we have introduced a new 'Accounting and Reporting this Quarter' round up to provide you with brief news on the most compelling recent events in the accounting and reporting arena.

In the 'News and Updates' section we chose the theme of the 'language' of accounting and how it evolves: If proposing a new definition of assets is the traditional mode of developing accounting, the IFRS online taxonomy is the tantalising and more innovative way for the accounting language to keep up with the business environment changes.

Our guest contributor provides us with a passionate reminder of the benefits of global accounting, from the perspective of education in our discipline, to which this newsletter humbly contributes. Michael Wells occupies a privileged position in the IASB's education initiative for observing this matter.

This edition's two core topics comprise exemplified explanations of two rather controversial areas of reporting: consolidation and emission trading schemes. Nicolas Perenchio uses his rigorous and plain narrative to address the latest developments in the requirements for business combinations. Jane Meade and Marco Marcellan address the topical matter of the carbon trading scheme, bridging the theory and the still rather short practice.

Finally, Stefano Bianchi's TopTenTopics goes philosophical and poses a Hamletian dilemma with regards to equity and liability. In his usual style, Stefano unveils challenges and proposes solutions based on his professional experience.

Your comments are very much welcomed. We know that some of the topics addressed in this edition have the power of stimulating debates at different levels. Whether your opinion is of a technical nature or of a more theoretical level, do consider using the editorial team as a hub to convey your comments to the authors.

Dr Marco Mongiello ACA
E: m.mongiello@imperial.ac.uk

Accounting and Reporting this Quarter

IASC/IASB

» go to www.iasb.com to follow up any of the following news

May 2010

The International Accounting Standards Board (IASB) published for public comment its proposed changes to the accounting for financial liabilities. This proposal follows work already completed on the classification and measurement of financial assets (IFRS 9 Financial Instruments).

The IASB is proposing changes to the fair value option responding to the view expressed by many investors and others that volatility in profit or loss resulting from changes in the credit risk of liabilities that an entity chooses to measure at fair value is counter-intuitive and does not provide useful information to investors.

=====================================

April 2010

The International Accounting Standards Committee (IASC) Foundation and the IASB have launched a programme to enhance investors' participation in the development of International Financial Reporting Standards (IFRS).

The investor outreach programme includes:

- Investor alerts
- Investor resources section of IASB website
- Dedicated plans to seek investor input for each project

=====================================

The IASB published for public comment an Exposure Draft of proposed amendments to IAS 19 Employee Benefits, proposing to amend the accounting for defined benefit plans through which some employers provide long-term employee benefits, such as pensions and post-employment medical care. In defined benefit plans, employers bear the risk of increases in costs and of possible poor investment performance.

The draft interpretation is open for comment until 6 September 2010.

=====================================

The IASB and the US Financial Accounting Standards Board (FASB) published a report on their work to improve and achieve convergence of International Financial Reporting Standards and US generally accepted accounting principles.

The report shows that good progress has been so far achieved towards the goal of convergence.

The next progress report is expected to be published in July 2010.

=====================================

The IASB and US Financial Accounting Standards Board (FASB) published for public comment an Exposure Draft on the reporting entity concept.

The proposals form part of a joint project to develop a common and improved Conceptual Framework that provides the basis for developing future accounting standards.

Comments on the exposure draft are invited by 16 July 2010.

=====================================

March 2010

The IASC Foundation published the second batch of training material for the IFRS for SMEs [see page 7 of this newsletter].

=====================================

January 2010

With regards to the situation when a contract is the purchase or sale of the underlying asset, the IASB tentatively decided that:

1. Contracts that transfer control of the underlying asset should be excluded from the scope of the proposed new leases requirements
2. The proposed new leases requirements should provide indicators to help a reporting entity determine whether control has been transferred
3. Management of the reporting entity should exercise judgement and consider all relevant facts and circumstances when determining whether control of the underlying asset has been transferred
4. Situations in which control of the underlying asset has normally been transferred include

   a. contracts where the title to the underlying asset automatically transfers

   b. contracts that include a bargain purchase option.

=====================================

Accounting and Reporting this Quarter

EFRAG

>> go to www.efrag.org to follow up any of the following news

March 2010

The European Financial Reporting Advisory Group (EFRAG) issued a draft comment letter broadly supportive of the IASB proposals with regards to the Exposure Draft Conceptual Framework for Financial Reporting: The Reporting Entity. The Exposure Draft focuses on the description and characteristics of a reporting entity and sets a definition of control as the basis for determining the boundaries of a reporting entity where it includes more than a single entity.

EFRAG issued a draft comment letter with comments on the IASB Exposure Draft Management Commentary, which was issued in June 2009. The letter states that EFRAG:

- supports the IASB's decision to develop high level, principle based, non-mandatory guidance on Management Commentary
- broadly supports the detailed proposals, except that EFRAG:
  - has concerns about the desirable qualitative characteristics of the proposed Management Commentary
  - does not support the IASB's decision to defer the development of placement principles until Phase E of the Conceptual Framework project
  - thinks that some sort of placement principles are necessary to increase financial reporting effectiveness where Management Commentary is prepared
- thinks it should be clarified that financial statements prepared in accordance with IFRS that are accompanied by Management Commentary, not prepared in accordance with the guidance proposed in the Exposure Draft, still can be said to be prepared in accordance with IFRS.

1 News and Updates

Marco Mongiello
A new definition of assets

Milestones

Objectives:

- To improve the IFRS/US GAAP definition of assets

Current status:

- New definition proposed in 2007 still being tested

What's next:

- There is not a timetable, but it is envisaged that the new definition will be adopted very soon

In February 2010, the EFRAG published a Research Paper produced by the Pro-active Project Group, on the proposed new Definition of an Asset tentatively adopted by the IASB and FASB, as part of their current work on the conceptual framework.

In the current IASB framework the definition is: "An asset is a resource controlled by the entity as a result of past events and from which future economic benefits are expected to flow to the entity."

The working definition agreed by the IASB and FASB is: "An asset of an entity is a present economic resource to which the entity has a right or other access that others do not have."

The purpose of this pro-active project is to "test whether the working definition of an asset as defined by the IASB/FASB staff team would work and result in an improvement over the existing IASB definitions of an asset". (Par. E2)

In 2007 the IASB and the FASB reached some consensus on the new definition of assets aimed at removing some of the difficulties of interpretation posed by the current one. However, it is perceived that not enough tests were carried out on the new definition. Carrying out tests on the new definition of assets consists of checking if a wide variety of examples of items (anything that is an asset according to the current definition or is intuitively amenable to be considered an asset) match the definition.

This process may appear disproportionate, where the two line definition of assets is the subject of several year long discussions as summarised in the aforementioned 58 page paper! On reflection, though, most preparers (and some thorough users) will find it advantageous not having to wrestle with the vague concept of 'control' and the sometimes challenging need to identify the 'past event' that relates to the asset, when identifying the same. Also, we all will appreciate some more guidance on the concept of 'economic resource'.

There are three main pillars of an asset and the proposed definition is aimed at assisting preparers and users in applying these. Here is how the proposed new definition addresses each of them:

- Control/Right: there is greater focus on the ability of the entity to obtain cash in-flows or reduce cash out-flows, shifting the focus even farther from the 'form' of control towards a full 'substance' approach
- Past/Present: greater consideration is given to the existence of the asset in the balance sheet than to any past event, which does not necessarily indicate existence at present
- Expectation/Capability: a more objective assessment is allowed of the capability of an item to emanate economic benefits, avoiding the more subjective exercise of guessing whether the entity will in fact obtain those benefits.

Keeping yourself updated, as a user or preparer of accounts, goes well beyond the mere acknowledgement of the new definition; it involves using the new definition to make your preparation work more efficient and your understanding more complete. This is, yet again, a reminder of how dynamic principle based accounting is and how prompt we must be in keeping up to pace with its multifaceted developments and adaptations to its users' informational needs.

This Newsletter will keep an eye on how the new definition will be accepted and implemented in practice.

Marco is Director of MSc Management and Teaching Fellow in Accounting at Imperial College Business School
E: m.mongiello@imperial.ac.uk

Bob Dohrer

IASC Foundation publishes proposed IFRS Taxonomy 2010

Milestones

Objectives:

- To improve the IFRS Taxonomy 2009

Current status:

- Final version published

What's next:

- IFRS Taxonomy 2011 - discussions starting in the second half of this year

eXtensible Business Reporting Language (XBRL) is a language that is used for the electronic communication of information between businesses and other users of financial information for the purpose of business reporting. A taxonomy is a computer-readable dictionary that defines business reporting terms and the relationships between them. At its simplest, XBRL may be thought of as "bar-coding" of financial information so that such information can be read, extracted and analysed in an automated fashion.

The IASC Foundation XBRL Team is responsible for developing and maintaining the XBRL taxonomy for International Financial Reporting Standards (IFRS), including the IFRS for Small and Medium-sized Entities (SMEs), known as the IFRS Taxonomy. The IFRS Taxonomy is used around the world to facilitate the electronic use, exchange and comparability of financial data prepared in accordance with IFRS.

On 19 February 2010, the IASC Foundation published for public comment an exposure draft of the IFRS Taxonomy 2010. The proposed taxonomy is consistent with IFRS and the IFRS for SMEs and contains significant architectural improvements over the 2009 version of the taxonomy; particularly the integration of IFRS and the IFRS for SMEs into a single taxonomy. Other technical improvements were made to the proposed taxonomy including an extended use of axes (dimensions) in the taxonomy, reconsideration of the approach for concept naming and reconsideration of the IASC's principle of deleting redundant concepts.

To facilitate review of the proposed taxonomy, the IASC Foundation provided a new tool - xIFRS (IFRS with XBRL). xIFRS supports viewing and understanding of the IFRS Taxonomy, without requiring any knowledge of XBRL. xIFRS provides a view of the electronic IFRS with embedded XBRL and it is available for both the IFRS and the IFRS for SMEs.

On a related note, the International Auditing and Assurance Standards Board (IAASB) has issued a Question and Answer publication entitled "XBRL: The Emerging Landscape," to raise awareness of how XBRL-tagged data is prepared and how it may affect financial reporting.

The final version of the IFRS taxonomy 2010 has just been released.

We will keep a close eye on the extent to which reporting entities will embrace this new version, as there is a great potential for enhancing comparability of accounts and making their analysis more efficient. Equally, however, before deploying any procedure or significant IT investment, we would check what momentum the XBRL 'language' worldwide adoption is gaining.

Bob is National Director of Assurance Services
McGladrey & Pullen, LLP
E: robert.dohrer@rsmi.com

2 The point of view of ...

Mike Wells

Discusses the benefits of global financial reporting standards from the view of the IASC Foundation's Education Initiative

Why global financial reporting standards?

We are now part of a new global capital environment in which multiple local GAAPs can impede the efficiency with which capital flows. Entities are competing in the global capital market for funds and investors charge a premium to digest unfamiliar GAAPs. Global standards also cut costs through standardised computer systems, streamlined consolidation procedures and efficiencies in education and training.

With IFRS increasingly being recognised as the global financial reporting language there's a huge opportunity for cost saving in individuals not needing to understand every country's local GAAP. One can increasingly focus on the quality of the comparable numbers being presented, and on providing financial information in a way that helps attract capital at the lowest cost. Accountants can then be put to more productive work. Consider the amount of time that must be spent on unnecessarily complicated consolidation processes when each country has its own GAAP. If everybody is reporting on a common basis, it is easier for people to make business decisions and to assess the quality of different entities' financial reporting.

Are global financial reporting standards a reality?

It is encouraging that over 100 jurisdictions now require or permit use of IFRS for preparing the consolidated financial statements of domestic listed companies and based on existing adoption plans the majority of the Fortune Global 500 companies are likely to use IFRS by 2015.

In September 2009, the G20 encouraged the IASB and the FASB to redouble efforts to achieve a single set of high quality, global accounting standards within the context of their independent standard setting process and to complete their convergence project by June 2011.

IFRS are also required or permitted to be used for financial reporting by domestic private entities in nearly 100 jurisdictions.

Why did the IASB issue a separate standard for SMEs?

The benefits of global financial reporting standards are not limited to entities whose securities are traded in public capital markets. The benefits are perhaps more obvious for a securities exchange listed multinational, but smaller unlisted entities benefit too. Smaller entities also operate across borders to import, export, borrow or seek venture capital from non owner managers. A purpose built common set of accounting standards facilitates small and medium-sized entities (SMEs) access to capital. SMEs may also have operations in more than one jurisdiction and therefore would also benefit from standardised computer systems and streamlined consolidation procedures.

Following the issue of the IFRS for SMEs by the IASB in July 2009 many jurisdictions have indicated that they are likely to require or permit use of the IFRS for SMEs by domestic private companies. Some jurisdictions already require use of the IFRS for SMEs (e.g. South Africa) for reporting by SMEs. Many others are considering requiring or permitting its use (e.g. the United Kingdom and Ireland).

Why principle based standards?

Many people find the idea of principle based global financial reporting standards desirable. They envisage that those standards are likely to function well across the world's jurisdictions and accommodate different legal frameworks, reduce financial structuring opportunities and result in a faithful representation of the underlying economic transactions and events in financial statements.

I have observed that principle based standards mean different things to different people. I see a requirement as principle based only when it is rooted in and is consistent with a formalised conceptual framework (e.g. the IASB's Framework for the Preparation and Presentation of Financial Statements: 'the Framework'). Some application guidance (good rules) may be necessary to give effect to the principle. Not all requirements in IFRSs are principle based–some IFRSs predate the Framework (e.g. IAS 20 Accounting for Government Grants and Disclosure of Government Assistance). However, because the IASB is guided by the Framework in the development of future requirements, IFRS should become increasingly principle based through time. When a new requirement is not based on the Framework, the IASB now gives reasons why they deviated from the Framework.

When a requirement is principle based one can build from the objective of financial reporting through the concepts set out in the Framework to the principle and explain how 'good' rules (e.g. some application guidance) give effect to the principle.

What is the IASC Foundation education initiative's role in training and education?

Much of the available IFRS training material is developed by academics and the bigger accountancy firms. The IASC Foundation's education initiative provides additional support in the form of IFRS summaries and guides and by arranging IFRS conferences and workshops. Recently we have focussed on building capacity for the implementation of the IFRS for SMEs. We are creating comprehensive training material to support the widespread implementation of the IFRS for SMEs, which potentially will be adopted by millions of entities around the world, including many in developing and emerging economies. The training modules can be downloaded from the IASB's website free of charge. We are also working with the world's development agencies and regional professional associations who are setting up regional IFRS for SMEs 'train the trainer' workshops. The first of these three-day workshops was held jointly with the Confederation of Asian and Pacific Accountants and with the financial support of the Asian Development Bank. Similar workshops are scheduled to be held in Africa, Latin America and the Caribbean during 2010.

Another important relationship is with the academic community, to help develop the capacity in students to make IFRS judgments. By teaching IFRS from its underlying concepts and foundations you can empower people to make the judgements necessary to apply principle based requirements in the real world. Many academics are very responsive to this. When changing from a local GAAP to IFRS it is a good opportunity to rewrite teaching material from a new perspective.

How do you see the future of IFRS training and education?

I think we are moving closer to more globally recognised accounting qualifications. Some accounting institutes have established offices in multiple jurisdictions, indicating a trend towards greater reciprocity and mutual recognition. One sees this already with initiatives such as the Global Accounting Alliance. IFRS accountants find their skills in demand wherever they are in the world.

Michael Wells is a Director of the IFRS Education Initiative at IASB
E: mwells@iasb.org

Guest Contributor
Michael Wells

Guest Contributor: Mike Wells

Michael Wells leads the education initiative of the International Accounting Standards Committee Foundation (IASC Foundation).

He qualified as a South African chartered accountant with Ernst & Young before being seconded to work out of the firm's Detroit office. He subsequently joined the academic world and became the Associate Professor responsible for the financial accounting section of a South African university.

He also served as an independent evaluator of professional qualifying examinations. He is a member of a number of international accountancy education advisory groups.

www.iasb.org

2 The point of view of ...

Nicolas Perenchio

Impacts of the implementation of revised IFRS 3 and IAS 27

IFRS 3R (business combinations) and IAS 27R (consolidated and separate financial statements) are effective for reporting periods beginning on or after 1 July 2009. For many groups this means the first financial statements to be impacted by these standards will be the financial statements as of 31 December 2010.[1]

A good understanding of the major changes borne by these revised standards is critical, as some of them may have significant consequences on the impacts and the presentation of external growth operations in the financial statements. This article deals with the issue of the impacts of a business combination on the consolidated financial statements with a focus on the valuation of the goodwill.

Until these standards were revised, groups were free to choose one of the two visions[2]. But now with the application of IFRS 3R and IAS 27R there is no choice: the financial communication of a group in the context of a business combination has to be based on the presentation of a global economic entity with two categories of shareholders (economic entity vision).

Another matter which has emerged in the international arena refers to the best way to measure goodwill in a business combination. IFRS has previously adopted a measurement method based on the acquiring entity's share (the partial goodwill method) whereas US GAAP adopted a measurement method based on the full value of the acquired entity, including the share of goodwill held by the non-controlling interest (the full goodwill method).

In the context of the convergence between IFRS and US GAAP, the IASB has decided to adopt a consensual position in the revised version of IFRS 3. Thus, groups now have the choice to calculate goodwill linked to a business combination according to one of the two methods; and this choice can be made for each business combination. This potentially raises a challenge, whereby if the reporting entities do not embrace a homogeneous approach in their business combinations, comparing financial statements will be much more difficult.

Thus a group which acquires control of a target in one transaction, but for less than 100%, will have to decide whether to account for it according to the full or partial goodwill method. In general terms, using the method of full goodwill will increase the amount of goodwill recognised as an asset as well as the portion of shareholders' equity attributed to the non-controlling interest. This choice could prove appealing for a group with relatively weak shareholders' equity and/or a high debt ratio. However, future impairment of the goodwill could be potentially significant.

In cases where an entity obtains control of a target in more than one stage it will be likely to see its financial statements substantially modified in the year of the takeover. Indeed, whereas previously the participation held prior to obtaining control was revalued via the shareholders' equity, under the revised standards, the gain or loss is recognised directly in profit or loss, despite the fact that it is not a 'true' realised gain. This concept is akin to that of assets measured at fair value through profit or loss where unreailsed gains and losses are also recognised directly in profit or loss.

Now we can see that the external growth policy (minority or majority acquisition, partial or full acquisition, in one or several stages) and the method chosen to measure the non-controlling interest and therefore recognise the goodwill (partial or full goodwill method) may considerably and for many years influence the impact of an acquisition on the financial statements and hence its performance indicators.

Even if accounting considerations do not prevail in decisions as strategic as acquisitions and transfers it is very important, where possible, to anticipate the consequences of combinations in order to choose the most favorable option for the presentation in the financial statements.

Let us analyse, through a simple example, the differences of the impacts of the three following approaches on the consolidated statement of financial position of a group:

- Approach 1: IFRS 3 and IAS 27
- Approach 2: IFRS 3R and IAS 27R according to the partial goodwill method
- Approach 3: IFRS 3R and IAS 27R according to the complete goodwill method.

Footnotes

[1] However, in jurisdictions where year ends are predominantly June, then it will apply at 30 June 2010

[2] Although the practice has very rarely seen divergent results, the current standard allows the adoption of two conceptual visions of the financial statements of a group: the first one gives priority to the major shareholder and is called the "consolidating entity vision"; in the other one, a global economic approach with two categories of shareholders (major and minority) is preferred and is called the "economic entity vision".

Approach 1	Approach 2	Approach 3
IFRS 3 and IAS 27	IFRS 3R and IAS 27R according to the partial goodwill method	IFRS 3R and IAS 27R according to the complete goodwill method

Step 1

An entity A is the group's parent company and presents its financial statements according to IFRS. Entity A acquires 20% of entity B for an amount of CU100. To simplify, the acquisition is financed with a loan. At that time, entity B's fair value is CU400.

Assuming that this acquisition gives entity A significant influence over entity B, entity A will account for its interest in entity B in its consolidated financial statements using the equity method. Entity B's shares will be accounted for in A's separate financial statements at their acquisition cost, being CU100.

Assets		**Liabilities and Equity**	
Goodwill		Shareholders' equity (group share) - Consolidated reserves - Net profit (group share)	
Investments in associates	100	Minority interests	
Net assets		Liability	100
TOTAL	**100**	**TOTAL**	**100**

Step 2

Entity A acquires an additional 40% of entity B for CU500. To simplify, the acquisition is financed with a loan. At that time, entity B's fair value is CU1,000. Assuming that this additional acquisition gives entity A control over entity B, entity A will consolidate entity B in the consolidated accounts.

Approach 1	Approach 2	Approach 3
Goodwill calculation Each successive acquisition must be analysed to calculate the goodwill linked to this takeover. The analysis is done on historic values for each component of goodwill: • Goodwill calculation linked to the first step: 100 - (20% x 400) = 20 • Goodwill calculation linked to the second step: 500 – (40% x 1,000) = 100 • Goodwill to be accounted for = 120 As such, there is no revaluation of the initial acquisition to FV at the date of the second acquisition. The NCI after this transaction is 500 (50% x 1,000).	**Goodwill calculation** The goodwill was calculated only once at its fair value at the acquisition date: (500 / 40% x 60%) – (60% x 1,000) = 150 Note: it is a simplified calculation; we consider each acquired share proportionally has the same value, without considering any control bonus. **Calculation of the net profit (group share)** The operation is likened to the transfer of an investment booked at its fair value followed by an acquisition of 60% of the entity B: (500 / 40% x 20%) – 100 = 150 Note: the revised standard increases the disconnection between the "cash" vision of the operation and its accounting translation.	**Goodwill calculation** The goodwill is calculated only once at its fair value at the takeover date for the total value of the entity: (500 / 40%) – 1,000 = 250 Note: it is a simplified calculation; we consider each acquired share proportionally has the same value, without considering any control bonus.

Cont'd >

Assets		Liabilities and Equity	
Goodwill	120	Shareholders' equity (group share): - Consolidated reserves (1000-400) X 20%	120
Investments in associates		Minority interests (1000x40%)	400
Net assets	1000	Liability (100+500)	600
TOTAL	**1120**	**TOTAL**	**1120**

Assets		Liabilities and Equity	
Goodwill	150	Shareholders' equity (group share): - Group share of net profit	150
Investments in associates		Minority interests	400
Net assets	1000	Liability (100+500)	600
TOTAL	**1150**	**TOTAL**	**1150**

Assets		Liabilities and Equity	
Goodwill	250	Shareholders' equity (group share): - Group share of net profit	150
Investments in associates		Minority interests (1250x40%)	500
Net assets	1000	Liability (100+500)	600
TOTAL	**1250**	**TOTAL**	**1250**

Step 3

The entity A acquires an additional 10% of entity B for CU110. To simplify, the acquisition is financed with a loan. At that time, entity B's global fair value is CU1,000.

In the three approaches, in the absence of contradictory information, this additional acquisition does not change the control over entity B. Thus, entity B is also integrated in the IFRS consolidated accounts with the full consolidation method.

This additional acquisition has consequences either on the goodwill (consolidating entity vision) or on the equity (economic entity vision). In our example, we consider that entity A chooses the consolidating entity vision.

Goodwill calculation

The acquired share completes the historic goodwill: 120 + (110 – 10% x 1,000) = 130

Note: in the absence of any takeover the analysis is based on the net values.

This additional acquisition has no impact on the goodwill calculated in step 2, approach 2. It is only a transaction between two categories of shareholders, which has an impact on equity.

Calculation of the consolidated reserves

The transfer income approach accounted for in step 2 approach 2 (150) is booked in the reserves. Besides, the difference between the price paid (110) and the net value of share acquired (1,000 x 10% = 100) is booked in the reserves (-10).

Calculation of group reserves value

The transfer income accounted for in step 2 approach 2 (150) is booked in the reserves. Besides, the difference between the price paid for this share (110 – (1,000 x 10%) = 10) and the value of the goodwill in the assets for the share acquired (250 x 10% = 25) is booked in the reserves (+15).

Assets		Liabilities and Equity	
Goodwill	130	Shareholders' equity (group share): - Consolidated reserve	120
Investments in associates		Minority interests (1000x30%)	300
Net assets	1000	Liability (100+500+110)	710
TOTAL	**1130**	**TOTAL**	**1130**

Assets		Liabilities and Equity	
Goodwill	150	Shareholders' equity (group share): - Consolidated reserve	140
Investments in associates		Minority interests (1000x30%)	300
Net assets	1000	Liability (100+500+110)	710
TOTAL	**1150**	**TOTAL**	**1150**

Assets		Liabilities and Equity	
Goodwill	250	Shareholders' equity (group share): - Consolidated reserve	165
Investments in associates		Minority interests (1000x30%)	375
Net assets	1000	Liability (100+500+110)	710
TOTAL	**1250**	**TOTAL**	**1250**

Nicolas is a Partner at
RSM Secovec, France
T: +33 2 51 83 30 30
E: nperenchio@rsm-secovec.com

The point of view of ... 2

Marco Marcellan & Jane Meade

Reporting Challenges Posed by Carbon Trading Schemes

Carbon emission schemes: moving towards a low-carbon economy

The final outcomes of the 15th United Nations Climate Change Conference (COP15), which concluded its activities on 18th December 2009, in Copenhagen (Denmark), might have disappointed many observers but have clearly indicated that carbon schemes are becoming more and more important tools for countries, cities, companies and communities to implement their initiatives towards global climate preservation. Moreover, COP15 represents a leap forward from the 1997 conference, which resulted in the infamous "Kyoto Protocol". That was the protocol that indeed established legally binding obligations for developed countries to reduce their greenhouse gas emissions, but that was conceived in a rather ineffective way and was not endorsed by some major players in the global economy.

In order to meet the targets set out in the Kyoto Protocol, countries are following various strategies [e.g. refer to the bill on cleaner technology being currently discussed in the US]. First they are setting out the so-called emission trading schemes in order to force entities to meet the targets. Broadly, there are two major types of emission rights schemes[3] commonly used:

Event	Cap and trade scheme	Baseline and credit scheme
Beginning of regulatory period	Participant allocated emission allowances	Participant allocated baseline
End of regulatory period	Participant must remit to regulator emission allowances equal to emissions during the regulatory period	Participant receives from (must remit to) the regulator emission credits equal to emissions below (above) the allocated baseline

Once the emission trading schemes are set up and properly running, the idea that is gaining momentum is to establish organised markets for carbon allowances and let the market forces find beneficial equilibria.

Accounting for green house gases (GHG): state of the art

Presently, there is no authoritative accounting literature in either IFRS or US GAAP that addresses accounting for emission rights. Both the IFRIC and the EITF have previously considered accounting for emissions trading schemes, but neither issued any guidance that was implemented in practice.

IFRS

In December 2004 the IFRIC rushed the issue of IFRIC 3, Emission Rights in order to be ready for the launch of the European Union Emissions Trading Scheme in January 2005.

However, EFRAG issued negative endorsement advice. Consequently the European Union discharged IFRIC 3 and this forced the IASB to withdraw IFRIC 3 in July 2005. EFRAG was concerned over the "mixed approach model" proposed by IFRIC which was seen as creating a measurement mismatch (whereby some items are measured at cost IAS 38 and IAS 20 and others at fair value IAS 37) and a reporting mismatch (whereby some gains and losses are reported in profit or loss (IAS 37 and IAS 20) and others in equity (IAS 38). Both the IFRIC and the IASB acknowledge that IFRIC 3 creates unsatisfactory measurement and reporting mismatches.

US GAAP

The FASB also tentatively tried to issue some guidance on emission rights in 2003. However, the Issue "Participants' Accounting for Emissions Allowances under a 'Cap and Trade' Program" lasted only one meeting and was then removed from the FASB's agenda.

On the other hand, the US Federal Energy Regulatory Commission (FERC) has issued accounting guidelines for entities that are subject to its oversight to follow in their regulatory financial statements. Those guidelines include specific guidance on accounting for emissions allowances.

When analysing the US GAAP literature, the staff of FASB noted that, in the absence of authoritative US GAAP pronouncements, entities regulated by the FERC apply the FERC guidance on emissions allowances in their general purpose financial statements.

Divergence in practice

The International Emissions Trading Association (IETA) in conjunction with PricewaterhouseCoopers in 2007 released the results of a Europe wide survey of the accounting approaches applied by major organisations which were significantly affected by the EU ETS.

Cont'd >

[3] Information for observers, IASB/FASB Meeting: 21 October 2008, Norwalk, Project: Emissions Trading Schemes, Accounting issues (Agenda Paper 9B)

2 The point of view of ...

	Approach 1	Approach 2	Approach 3
Initial recognition - Allocated allowances	Recognise and measure at **market value** at date of issue; corresponding entry to government grant.		Recognise and measure at cost, which for granted allowances is **nil**.
Initial recognition - Purchased allowances	Recognise and measure at **cost**.		
Subsequent treatment of allowances	Allowances are subsequently measured at **cost or market value**, subject to review for impairment.		Allowances are subsequently measured at **cost**, subject to review for impairment.
Subsequent treatment of government grant	Government grant **amortised** on a systematic and rational basis **over compliance period.**		
Recognition of liability	Recognise liability when incurred (i.e. as emissions are produced).		Recognise liability when incurred (ie as emissions are produced). However, the way in which the liability is measured (see below) means that often no liability is shown in the statement of financial position until emissions produced exceed allowances allocated to entity.
Measurement of liability	Liability is measured based on the **market value** of allowances at each period end that would be required to cover actual emissions, regardless of whether the allowances are on hand or would be purchased from the market.	Liability is measured based on the **carrying amount** of **allowances on hand** at each period end to be used to cover actual emissions (i.e. market value at date of recognition if cost model is used; market value at date of revaluation if revaluation model is used) on either a FIFO or weighted average basis; plus the **market value** of allowances at each period end that would be required to cover any **excess emissions** (i.e. actual emissions in excess of allowances on hand).	Liability is measured based on the **carrying amount of allowances on hand** at each period end to be used to cover actual emissions (nil or cost) on a FIFO or weighted average basis; plus the **market value** of allowances at each period end that would be required to cover any **excess emissions** (i.e. actual emissions in excess of allowances on hand).

The survey revealed that European companies use three different accounting approaches to reporting emission allowances. Quite interestingly, the Association of Chartered Certified Accountants (ACCA)[4] based in the UK, reached a similar conclusion with a survey carried out a couple of years later. A summary is proposed above[5]:

It is noteworthy that approach 1 goes very much along the lines of IFRIC 3.

Three notable examples of the application of each approach have been extracted from companies' annual reports and are provided in the following page.

Current IASB project on Emission Rights

The objective of the current project on Emission Rights is to issue a separate IFRS on Accounting for Emission Rights. This project forms part of the Memorandum of Understanding between the IASB and the FASB which sets out a Roadmap of Convergence between IFRS and US GAAP 2006-2008.

The IASB held its last meeting on Emission Trading Schemes on 15 December 2009. The project is still in its early stages, with the Exposure Draft expected by the end of 2010 and the final standard is planned to be finalised by the end of 2011.

In our view, consistency in recognition and measurement of emission allowances and corresponding obligations is paramount, hence the IASB should, in drafting the ED, aim at simplifying the current scenario and prevent a further proliferation of policies, by endorsing approach 2 and approach 3 and moving away from approach 1. It seems to us that this would be the natural development from IFRIC 3, given that both approach 2 and 3 have almost spontaneously been proposed by constituencies and:

(i) approach 2 is very similar to IFRIC 3, with the addition of the distinction of treatment of the allowances on hand, as opposed to those needed for any excess emission. This distinction enables a more transparent representation of the reality, given that the use, value and cost of the allowances is substantially different, according to where and when they have been originated

(ii) approach 3 is a simpler version of approach 2 and could be recommended particularly where there is no active market for the allowances. This would prevent preparers from having to artificially devise fair values using non-conclusive techniques as required by the dreaded IAS 39. However, the fact that granted allowances is nil on initial recognition raises a big question mark on the usefulness of this solution.

[4] Carbon Jigsaw Briefing: Emission Rights Accounting, Association of Chartered Certified Accountants (ACCA), 2009.
[5] Excerpt from "Trouble-Entry Accounting – Revisited*, Uncertainty in accounting for the EU Emissions Trading Scheme and Certified Emission Reductions". Issued in May 2007 by the International Emissions Trading Association (IETA) in conjunction with PricewaterhouseCoopers.

Whatever approach is taken in the final standard, the decisions made in this project will have an impact on other standards (in particular IAS 20, IAS 38 and IAS 37). IAS 20 is a "weak" standard and needs to be replaced. IAS 38 allows fair value measurement only when an active market exists. IAS 37 does not contemplate fair value as a measurement attribute. We would recommend a comprehensive revision of the interrelation between those standards and the framework as well.

Example of application of approach 1

Repsol YPF, SA – 31 December 2008 – government grants approach

Emission allowances are recognised as an intangible asset and are measured at acquisition cost [representing market value].

Allowances received for no consideration under the National Emission Allowance Assignment Plan are initially recognised at the market price prevailing at the beginning of the year in which they are issued, and a balancing item is recognised as a grant for the same amount under deferred income, which is charged against income as the corresponding tons of CO2 are consumed.

These allowances are not depreciated as its book value equals the residual value and, therefore, its depreciable basis is zero, as these keep its value until delivery, meanwhile these may be sold anytime. The rights of emissions are subject to an annual analysis on impairment [...]. The market value of the emissions allowances is measured according to the average price of the stock market of the European Union (European Union Allowances) provided by the ECX-European Climate Exchange.

As the emissions are released into the atmosphere, the Group records an expense on the heading "other operating expenses" in the consolidated income statement acknowledging a provision whose amount is based on the CO2 tons emitted, measured, (i) at its book value or (ii) by the quotation price at closing in case Repsol YPF does not have enough emission allowances available for the period. In 2008, the net effect in the income statement of the Group due to the transactions related with the emissions allowances amounted to EUR 16 million, 2007 amounted to less than EUR 1 million.

When the emissions allowances for the CO2 tons emitted are delivered to the authorities, the intangible assets as well as their corresponding provision are derecognised from the balance sheet without any effect on the income statement.

Example of application of approach 2

Stora Enso (2008) Notes to the Consolidated Financial Statements (Extract) Note 1 Accounting Principles (Extract) Emission Rights and Trading

The Group's participation in the European Emissions Trading Scheme, in which it has been allocated allowances to emit a fixed tonnage of carbon dioxide in a fixed period of time, gives rise to an intangible asset for the allowances, a government grant and a liability for the obligation to deliver allowances equal to the emissions that have been made during the compliance period. Emissions allowances recorded as intangible assets are recognised when the Group is able to exercise control and are measured at fair value at the date of initial recognition. If the market value of emission allowances falls significantly below the carrying amount, and the decrease is considered permanent, then an impairment charge is booked for allowances that the Group will not use internally. The liability to deliver allowances is recognised on the basis of actual emissions; this liability will be settled using allowances on hand, measured at the carrying amount of those allowances, with any excess emissions being measured at the market value of the allowances at the period end.

In the Income Statement, the Group will expense, under Materials and Services, emissions made at the fair value of the rights at their grant date, together with purchased emission rights at their purchase price. Such costs will be offset under Other Operating Income by the income from the original grant of the rights used at their fair value at the grant date, together with income from the release or sale of surplus rights. The Income Statement will thus be neutral in respect of all rights consumed that were within the original grant; any net effect represents the costs of purchasing additional rights to cover excess emissions, or the sale of unused rights, or the impairment of allowances not required for internal use.

Example of application of approach 3

Centrica plc – 31 December 2008 – net liability approach

EU Emissions Trading Scheme and renewable obligations certificates

Granted CO2 emissions allowances received in a period are initially recognised at nominal value (nil value). Purchased CO2 emissions allowances are initially recognised at cost (purchase price) within intangible assets. A liability is recognised when the level of emissions exceed the level of allowances granted. The liability is measured at the cost of purchased allowances up to the level of purchased allowances held, and then at the market price of allowances ruling at the balance sheet date, with movements in the liability recognised in operating profit. Forward contracts for the purchase or sale of CO2 emissions allowances are measured at fair value with gains and losses arising from changes in fair value recognised in the Income Statement. The intangible asset is surrendered at the end of the compliance period reflecting the consumption of economic benefit. As a result no amortisation is recorded during the period.

Marco is a Partner in RSM Italy S.p.A
T: ***+39 3453778437***
E: ***marco.marcellan@rsmitaly.com***

Jane is National Technical Director at RSM Bird Cameron, Australia
T: ***+ 61 2 8226 9518***
E: ***jane.meade@rsmi.com.au***

3 Top Ten Topics in IFRS

Stefano Bianchi...
Debt vs. Equity

"Equity or Debt, that is the question". Financial statements' preparers and auditors seem to echo the Hamletian dilemma when faced with this choice in their practice. In the past, many sophisticated financial instruments have been issued by companies and the classification either in equity or as financial liability impact the Income Statement because changes in the value of equity are not accounted for in the financial statements, but changes in the value of financial liability are. "The substance of a financial instrument, rather than its legal form, governs its classification in the entity's statement of financial position. Substance and legal form are commonly consistent, but not always. Some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities."[6]

Definition of equity and financial liability

The starting point question is: "What is equity?" Equity is defined as the residual interest in the entity's assets after deducting its liabilities: typical examples of components of equity are common shares, reserves of past and current profit and other reserves. Equity is usually denoted with different descriptions in financial statements (e.g. owners' equity or interest, shareholders' equity or interest, capital, shareholders' funds and proprietorship). Equity ranks after liabilities as a claim to the assets of an entity.

A financial liability is any contractual obligation to deliver cash or another financial asset to another entity; or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

Compound instruments

More complex financial instruments can be both equity and liability! These instruments are called compound instruments and in recent years many companies and financial institutions have utilised them. A common example is a convertible bond, where the investor is able to convert the bond (a debt instrument) into shares rather than receive the principal paid in cash upon maturity. In this case, the issuer needs to split the two components (equity and liability) so the fair value of the financial liability is determined first, and the residual is recorded as equity. Cash received from the investors less the fair value of the liability equals the equity portion.

Top Ten Topics

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

"In April 2006, Bayer Capital Corp. b.v. issued a subordinated mandatory convertible bond guaranteed by Bayer AG with a coupon of 6.625% and a nominal volume of €2,300 million as part of the financing of the acquisition of Schering AG, Berlin, Germany. The outstanding units of this bond were converted into 62,604,583 new shares in 2009."[7]

The impact on the calculation of the Earnings per share needs to consider the effect of the dilution arising from the conversion of such instruments. Bayer Group in the 2009 financial statements reports as follows:

	2008 Shares	2007 Shares
Weighted average number of issued ordinary shares	764,342,029	801,050,237
Potential shares to be issued upon conversion of mandatory convertible bond	59,893,122	24,955,936
Adjusted weighted average total number of issued and potential ordinary shares	824,235,151	826,006,173
Core earnings per share from continuing operations (EUR)	4.17	3.64

[6] Par. 18 IAS 32 Financial Instruments: Presentation
[7] Bayer Annual report 2009, pag. 75

Preference shares

A preference share that provides for mandatory redemption by the issuer for a fixed or determinable amount at a fixed or determinable future date, or gives the holder the right to require the issuer to redeem the instrument at or after a particular date for a fixed or determinable amount, is a financial liability[8].

RBS in 2007 financial statements indicated that "Under IFRS certain of the Group's preference shares are classified as debt and are included in subordinated liabilities on the balance sheet" as shown below:

	Group		Company	
	2007 £m	**2006 £m**	**2007 £m**	**2006 £m**
Dated loan capital	23,065	13,772	5,585	5,531
Undated loan capital	9,866	9,555	781	834
Preference shares	1,686	2,277	1,377	1,829
Trust preferred securities	3,362	2,050	—	—
	37,979	**27,654**	**7,743**	**8,194**

Certain preference shares issued by the company are classified as liabilities, these securities remain subject to the capital maintenance rules of the Companies Act 1985.

However, often it can be complex to measure how much of the preference share should be reported as equity or difficult to consider them a financial liability altogether: for example, some entities have issued non-redeemable instruments with the so-called "dividend blocker clause" that implies that a dividend will be paid up to a capped maximum amount and no dividend can be paid to ordinary shares until the fixed dividend is paid and they have considered such instruments as equity. However, complying with the substance over form principle, these instruments could well be partially classified as liability. For example: a 4% cumulative non-redeemable preference shares would be split on initial recognition, with the fair value of a fixed interest instrument paying 4% in perpetuity being classified as a liability, and any difference between that and the issue price of the shares being classified as equity.[9]

Another example is provided by perpetual preference shares. Dividends are contractually required and paid at a fixed rate. However, the dividend may be settled in cash or in shares of an equivalent market value at the date on which the dividend is due, at the issuer's option. In this case, considering that there is no contractual obligation to deliver cash, these are equity[10].

Acquisitions and Earn-out

In almost all acquisitions Share Purchase Agreements (SPA) include a mechanism of earn-outs for the benefit of the sellers. Such earn-outs are adjustments to consideration, which relate to events or conditions that might trigger the settlement of additional consideration. For example, if the acquired target's EBTDA reaches a certain amount after three years, an additional amount will be paid as additional consideration.

Earn-outs can be settled through the acquirer's additional equity securities or in cash. These share-denominated earn-outs will need to be classified as liability or equity instruments, depending on their contractual terms. If they are liability, they are initially recognised at fair value and then remeasured at fair value at each reporting period, with changes in fair value accounted for in the income statement, whilst, if they are considered equity, they will not affect the entity's income bottom line, as they will not be remeasured.

If there is one good outcome of the current financial crisis, it is that it has reduced the attractiveness of complex financial instruments. Investors are warier of the hidden risks borne by these instruments and fear the much higher volatility of their values. This, in turn, reverberates in the quality of the firms' accounts where items' values are more reliable and less often the professional (but still subjective) judgement of the preparers is invoked in the items' classification. The users of the accounts should exercise their critical evaluation with respect to the assumptions, disclosed in the accounts, underpinning classifications and valuations.

Stefano is a Partner in RSM Italy, S.p.A
T: + 39 049 8750 295
E: stefano.bianchi@rsmitaly.com

[8] Par. 18 IAS 32 Financial Instruments: Presentation

[9] The split between liability and equity would be calculated by referring to the difference between the net present value of the future cash flows proceeding as fixed dividend and the nominal fair value of the shares when issued. The discounting rate, in this calculation, is the 'appropriate' interest of a similar, but wholly debt, instrument.

[10] Note that obligation here is to deliver equity instruments rather than cash or other financial assets.

RSM! International
global excellence in audit, tax & consulting

Global Contacts

Americas

Bob Dohrer
T: +1 919 645 6819
E: robert.dohrer@rsmi.com

Europe

Stefano Bianchi
T: +39 049 875 0295
E: stefano.bianchi@rsmitaly.com

Asia Pacific

Jane Meade
T: +61 2 8226 9518
E: jane.meade@rsmi.com.au

Middle East

Chandra Sekaran
T: +965 2245 2680
E: chandra.sekaran@albazie.com

Africa

Simon Fisher
T: +254 20 4451747/8/9
E: sfisher@ke.rsmashvir.com

RSM Global Executive Office - UK

Ellen Costa
T: +44 (0)20 7601 1080
E: ellen.costa@rsmi.com

Dr Marco Mongiello ACA
Director MSc Management
Teaching Fellow in Accounting
Imperial College Business School
T: +44 (0)20 7594 9686
E: m.mongiello@imperial.ac.uk

The publication is not intended to provide specific business or investment advice. No responsibility for any errors or omissions nor loss occasioned to any person or organisation acting or refraining from acting as a result of any material in this publication can be accepted by the authors or RSM International. All opinions expressed are those of the authors and not necessarily that of RSM International. You should take specific independent advice before making any business or investment decision.

RSM International is the name given to a network of independent accountant and consulting firms each of which practices in its own right. RSM International does not exist in any jurisdiction as a separate legal entity. The network is administered by RSM International Limited, a company registered in England and Wales (company number 4040598) whose registered office is at 11 Old Jewry, London EC2R 8DU. Intellectual property rights used by members of the network including the trademark RSM International are owned by RSM International Association, an association governed by articles 60 et seq of the Civil Code of Switzerland whose seat is in Zug. © RSM International Association, 2010