Deloitte Touche Tohmatsu

Accounting Alert

A focus on technical accounting issues *No. 10*

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IAS 37 / ED-86: Provisions

Useful guidance on; identification of obligations, discounting future cash flows, consideration of effect of expected future events, and restructuring provisions.

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On trial!

A new approach to the development of accounting standards

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Two new exposure drafts have been released by the Financial Reporting Standards Board (Board). They deal with Intangible Assets and Provisions, Contingent Liabilities and Contingent Assets. The development of these exposure drafts heralds a new experimental regime for exposure drafts in New Zealand and comments are sought as to the appropriateness of this new policy.

Accompanying each of these exposure drafts are the following documents:

- The IASC pronouncement,
- Discussion paper dealing with what the implications of this standard are for entities in New Zealand,
- Discussion questions.

The Board agreed in 1997 that future New Zealand FRSs would be developed based on standards issued by the International Accounting Standards Committee (IASC) or the Australian Accounting Standards Board (AASB). The two newly issued exposure drafts (EDs) were based on the International positions, because the Australians have not as yet developed their own standard on these two topics.

The Board's current approach to implementing this new policy is to issue either the relevant IASC or AASB pronouncement (subject to minor terminology and format changes) as the New Zealand ED for certain new projects, and highlight significant issues in the discussion paper accompanying the ED.

Under this approach, the exposed ED will not necessarily represent the Board's intended position for the final financial reporting standard (FRS). The Board's intended position, where it departs from the ED, will instead be identified in the discussion paper.

The discussion paper is therefore an essential supplement to the ED and will specifically:

- Outline the implications for New Zealand entities , of the IASC or AASB position adopted in the ED, and
- Identify the Board's intended position where proposals in the ED differ from the requirements of existing New Zealand pronouncements, or where the Board does not consider that a requirement in the ED is appropriate for the New Zealand environment.

Specific circumstances in which the Board may impose changes to the IASC are identified in the ED. These are designed to achieve consistency and compatibility with existing New Zealand FRSs or the Statement of Concepts, or to accommodate particular features of the New Zealand legal, public sector and commercial environment.

Generally we are in favour of this new approach to the development of accounting standards and look forward to future exposure drafts which will be based on this approach. However, we believe that there can still be some improvements. From a procedural perspective, it would seem better to expose the International or Australian accounting standard when it is in exposure draft form and seek local comments as part of the global submission process. This would ensure that we have input into the development of these standards, rather than waiting for the applicable international standard to be finalised and then released as an exposure draft in New Zealand.

With the current new process, if we are serious about harmonisation, are we realistically going to make changes from the internationally agreed position based on submissions received locally? With the world increasingly becoming a global village, harmonisation is important even if we don't always agree with decisions made internationally. ■

To be, or not to be?

An intangible question

Q. When is an intangible 'asset' such as a brand or trademark not an asset?

A. When it does not meet the proposed rules for recognition under the Institute's new exposure draft ED-87: Accounting for Intangible Assets.

ED-87 is based on the corresponding International Accounting Standard, IAS-38: Intangible Assets, in line with the Institute's policy of harmonisation. Like IAS-38, it takes a conservative stance on allowing entities to recognise those less-than-tangible rights as assets in their financial statements. Recognition of internally generated brands, mastheads, publishing titles and customer lists is specifically prohibited. It also prohibits revaluation of intangible assets unless there is an active market and a listed market price. Amortisation of all intangible assets is required and a 20 year limit (with certain stringent exceptions) has been set. The exposure draft proposes to require entities to apply the standard retrospectively. ED-87 is a conservative offering and will not sit well with a number of New Zealand companies.

To be

An intangible asset should be recognised, at cost, if it meets the following criteria:

- it is identifiable (ie distinguishable from goodwill);
- the entity has control over the future economic benefits associated with the asset;
- the future economic benefits associated with the asset are probable; and
- the cost of the asset can be measured reliably.

Not to be!!

Clarification of the intangible asset definition in the exposure draft spells the death knell for some assets which entities may currently recognise. In particular, an entity must be able to demonstrate control of the future economic benefits expected to be derived from the asset. For example, in the absence of a legal right, an entity is unlikely to be able to demonstrate control of the benefits expected to be derived from expenditure on staff (eg training costs) or on building or maintaining customer portfolios. This is because generally an entity cannot control an employee's or a customer's future actions and it may not realise the benefits it expected to generate from the expenditure. An entity will no longer be able to defer and amortise such costs.

The basic rule is that all expenditure must be expensed when incurred unless it forms part of the cost of an intangible asset as defined. In particular the exposure draft lists certain types of expenditure that must be expensed as incurred, including research costs, start-up costs, training costs; costs of advertising and promotional activities, and relocation or reorganisation costs.

Internally generated items – Brands, Mastheads, Publishing Titles, Customer List etc

One of the more controversial aspects of the exposure draft relates to the non-recognition of **internally generated** brands, mastheads, publishing titles, and customer lists. An entity will not be permitted to recognise **internally generated** brands, mastheads, publishing titles, customer lists and other similar items. This is because the exposure draft takes the view that expenditure on internally generated brands etc cannot be distinguished from the cost of developing the business as a whole and it will therefore not permit recognition of these items as assets. Those entities which have recognised internally generated brands in the past will be required to eliminate those assets from their statements of financial position.

Measurement

Purchased Items

Purchased intangibles are recognised at cost. If the asset was acquired in a business combination then the asset must be recognised at fair value. If there is no quoted market price for the asset, then a recognised fair value technique, which is current in the industry to which the asset belongs, may be used (eg discounted cash flows). If there is no quoted market price for the asset, the cost initially recognised for the intangible asset is limited to an amount that does not create or increase any negative goodwill (discount on acquisition) arising at the date of acquisition.

Internally Generated Assets

Internally generated assets may be recognised provided they fall within the intangible asset definition and meet the recognition criteria. They can only be capitalised provided they have a reliable cost and costs can only be capitalised from the date that the asset meets the criteria. Costs prior to this date must be expensed. The exposure draft classifies the generation of an asset into a research phase and a development phase. Consistent with FRS-13: Accounting for Research and Development Activities which will be replaced by this exposure draft when it is finalised, research costs are expensed and only development costs are capitalised. In order to recognise an internally generated intangible asset, similar criteria to those under FRS-13 for capitalising development costs (eg technical feasibility, market for the asset, reliable cost etc) must be met. Where amounts have been expensed as incurred, these cannot then be reinstated as part of the cost of the asset.

Revaluation

Another controversial aspect of the exposure draft is the requirement for an active market in order to revalue intangible assets. An active market is a market where all the following conditions exist:

a) the items traded within the market are homogeneous;
b) willing buyers and sellers can normally be found at any time; and
c) prices are available to the public.

If the entity elects to revalue, then the asset must be revalued, (at least annually), at the quoted market price. It is probably fair to say that it is unlikely that there will be an active market for most intangible assets owned by New Zealand entities and therefore most intangible assets will have to be stated at cost less amortisation. An entity is not permitted to use any other fair value techniques to revalue its intangible assets. If an entity elects to revalue, the asset must have been recognised at cost initially. Entities which have previously revalued their intangibles using a value other than a quoted market price, will be required to restate those assets at (amortised) cost.

Amortisation

Intangibles must be amortised over their estimated useful lives as the exposure draft considers that all intangibles have a finite life. There is a rebuttable presumption that the useful life will not exceed 20 years. If the entity can rebut the presumption, then it is permitted to amortise over a longer period provided it discloses the reasoning for the longer period in the financial statements. If control of the asset is achieved through legal rights that have been granted for a finite period, the useful life must not exceed the period of the legal rights unless the renewal of the rights is virtually certain. The exposure draft will not permit a residual value to be taken into account unless there is a legal contract with a third party to sell the asset at that amount.

Interestingly there is an apparent disparity between ED-83 Accounting for Acquisitions Resulting in Entity Combinations and ED-87. ED-83 requires goodwill to be amortised over 10 years (extendable to a maximum of 20 years if there is persuasive evidence that the life is longer than 10 years). ED-87 allows intangibles to be amortised over a period up to 20 years (or longer as noted above). The corresponding international standards on goodwill and intangibles (IAS-22 and IAS-38) have the same rule for both types of asset. They assume that the life of each will not exceed 20 years but allow a longer period if there is persuasive evidence that the life is longer. ED-83 appears then to have taken a very conservative position. We would prefer to see the rules lined up for both classes of assets to avoid any potential for abuse.

Impairment

An entity must review both the period and method of amortisation annually to ensure that these remain appropriate. In addition, it must perform an impairment test annually for intangible assets still in development and those which are being amortised over more than 20 years, even if there is no indication that those assets are impaired.

Transitional provisions

There are a number of transitional provisions depending on the circumstances that led to the recognition of the asset in an entity's financial statements. The general rule that the exposure draft is proposing requires retrospective application of the standard with any one-off adjustment being treated as a prior period adjustment. Assets which do not meet the criteria in the exposure draft will be derecognised.

Final comment

It is worth noting that Australia has not issued an exposure draft on the subject as yet and it could be some time before it does. 'Make haste slowly' may be the order of the day. ■

IAS 37 / ED-86 vs Statement of Concepts - You be the Judge

Contingent liabilities and contingent assets.

The section of IAS 37 which deals with contingent assets has been received with a great deal of surprise in New Zealand and Australia. The International Accounting Standards Committee (IASC) seems to have strayed from its own *Framework for the Preparation and Presentation of Financial Statements* (Framework) in that the IAS 37 definition and recognition criteria for *contingent assets* appear to be markedly different to the asset definition and recognition criteria of the Framework. Whereas the Framework [and our equivalent *Statement of Concepts for General Purpose Financial Reporting* (Statement of Concepts)] prescribes an even-handed treatment of assets and liabilities, IAS 37 has returned to the out-of-date prudence concept. IAS 37 requires contingent liabilities to be recognised as liabilities if it is probable (more likely rather than less likely) that an outflow of resources will occur, but it only allows the recognition of contingent assets as assets if it is virtually certain that the inflow of economic benefits will occur.

Whilst ED-86 is a copy of IAS 37, it is the intention of the Financial Reporting Standards Board (Board) to divert from the IASC's standard where it conflicts with the Statement of Concepts.

Contingent Liabilities

A *contingent liability* has been defined in IAS 37 and ED-86 as:

a) *a possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or*

b) *a present obligation that arises from past events but is not recognised because:*

(i) *it is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or*

(ii) *the amount of the obligation cannot be measured with sufficient reliability.*

A contingent liability is not recognised in the statement of financial position. IAS 37 and ED-86 require the disclosure of a contingent liability by way of note unless the possibility of an outflow of resources is remote.

Contingent Assets

Significant changes are proposed to the IAS 37/ED-86 definition and recognition criteria in regard to contingent assets. The reasons for the intended changes are:

- the inconsistencies between the IAS 37 definition and criteria and those of the Statement of Concepts, and
- the lack of symmetry between contingent assets and contingent liabilities, whereas the Statement of Concepts provides symmetry of definition and disclosure criteria between assets and liabilities.

Definition

The IAS 37/ED-86 definition of a *contingent asset* is:

A possible asset that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity.

The Board proposes to widen the definition, to read as follows (new wording shown in bold):

A contingent asset is:

(a) *a possible **benefit or claim** that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or*

(b) an asset that arises from past events but is not recognised because:

(i) it is not probable that the service potential or future economic benefits embodied in the asset will eventuate; or

(ii) the asset possesses a cost or other value that cannot be measured with sufficient reliability.

The additional paragraph (b) widens the definition to align it with the *contingent liability* definition.

The proposed widening of the definition from a *possible asset* to a *possible benefit or claim* would bring internally generated goodwill and unrecognised internally generated intangible assets into the contingent asset disclosure regime. It has been noted that it may not be practicable to estimate the financial effect of such contingent assets and the Board considers that the financial effect should only be required to be disclosed when there is no adverse cost to the entity in gathering and reporting this information. However, when the value is disclosed, it must be accompanied by a description of the basis on which it has been prepared and a statement as to whether the estimate has been prepared by an independent and qualified valuer.

Recognition and Disclosure Criteria

The Board proposes to amend ED-86/IAS 37 recognition and disclosure criteria to bring them into line with the Statement of Concepts. The proposed variations from the International standard are shown below.

•Criteria for recognition as an asset:

IAS: Virtually certain.

Proposed: Probable (ie more likely rather than less likely).

IAS and Proposed: *Can be measured with reliability.*

•Criteria for disclosure by way of note:

IAS: Probable.

Proposed: More than remotely likely but less than probable. If only remotely likely, disclose if knowledge of the transaction or event is relevant to users of the financial report.

IAS 37 / ED-86: Provisions

The Financial Reporting Standards Board has issued an exposure draft and discussion paper entitled Provisions, Contingent Liabilities and Contingent Assets as a response to the publication of IAS 37 by the International Accounting Standards Board.

As a result of the impact of the Statement of Concepts for General Purpose Financial Reporting (Statement of Concepts), preparers and users of financial statements will have been well prepared for the *provisions* aspect of the proposed new accounting standard.

Provisions are defined as liabilities of uncertain timing or amount. Important proposed, specific additions to New Zealand generally accepted accounting practice are:

- *Obligations* are carefully defined. They are either *legal obligations,* which embody commitments as a result of a legally binding contract, legislation or other operation of law; or *constructive obligations,* which are not so easily identified. They require an *indication* to other parties of acceptance of responsibilities, given in such a way that they create valid expectations of those other parties that those responsibilities will be discharged (a commentary paragraph explains that the entity should have no realistic alternative to settling the obligation). The aforementioned *indication* could be as a result of an established pattern of past practice, published policies or a specific current statement.
- In establishing the amount of the provision, the expected future cash flows must be *discounted,* if this will have a material effect.
- *Future events* may be taken into account in measuring the provision, provided there is sufficient evidence to confirm that those events will occur. If the future events are the passing of new legislation, IAS 37 requires *virtual certainty* that they will occur. The Discussion Paper proposes to amend this to a *probability* (more likely rather than less likely to occur) requirement in order to comply with the Statement of Concepts.
- IAS 37 requires any expected reimbursements to be *virtually certain* in order to be taken into account. The Discussion Paper proposes to amend this to a *probability* requirement to bring it in line with the Statement of Concepts.
- Provision must be made for *expected losses* on non-cancellable onerous contracts (where unavoidable costs are expected to exceed future benefits).
- *Restructuring provisions* cannot be recognised unless a detailed formal plan has been prepared. The plan must identify the business or part business to be restructured, the principal locations which will be affected, the expenditures to be undertaken and the date of implementation. Staff compensation provisions require the number, location and function of the employees to be included in the detailed plan. A commitment must have been established by building up a valid expectation of those affected as a result of the commencement of the operation or an announcement to those affected. Restructuring provisions should include only direct expenditures that are necessarily entailed by the restructuring and must not be associated with any ongoing activities. They do not include such costs as retraining or relocating continuing staff, marketing or investment in new systems and distribution networks. ■

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