

RSM! Reporting

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

In this issue:

Section 1: News and updates

*Marco Mongiello on IFRS 9:
Will it ever be endorsed by
the EU?*

*Joseph Ellul Falzon on
Management Commentary*

Section 2: The point of view of ...

*...Francesco Bellandi on The
Other Comprehensive Income
Dilemma*

*...KC Rottok on Auditing
Impairment Tests During a
Recession*

*...Jude Doliente on Credit Risk
in Liability Measurement*

Section 3: Top Ten Topics in IFRS

by Stefano Bianchi

Welcome from the Editor Marco Mongiello

The editorial team wishes that all RSM Reporting's readers have started the New Year under the best auspices of success and prosperity. The time of the year when we all commit to new resolutions has just gone by and we are left with the wish that projects pending from the past year will finally see a successful completion this year. I personally wish that in 2010 we can see significant achievements in the quest for more transparency, consistency and clarity in the pending projects of the IASB.

In this edition of RSM Reporting, we have chosen to explore new *widths* and *depths* of accounting.

Our guest contributor, Francesco Bellandi, author of a recent comprehensive manual of comparative accounting, explores the width of the gap between IFRS and US GAAP. In his contribution on 'other comprehensive income', he highlights some critical aspects on the road to full consistency between IASB and FASB.

On more technical matters, we see what depths into other disciplines accounting can reach: KC Rottok unravels the complexity of impairment tests, where various finance techniques can be used and mis-used; Jude Doliente explains the multifaceted task of assessing credit risk in liability management. Finally Stefano Bianchi, carrying on covering his Top Ten Topics, addresses the challenges posed by using different techniques, in different contextual and theoretical premises, for the purchase price allocation, i.e. how goodwill can be transferred to intangible assets.

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



Marco Mongiello

IFRS 9: Will it ever be endorsed by the EU?

Milestones

Objectives:

- > To replace IAS 39

Current status:

- > IFRS 9 published with no EFRAG endorsement
- > ED on impairment of financial assets open for comments until 30th June 2010

What's next:

- > ED on hedge accounting to be published in the first quarter of 2010

IAS 39 is an endless source of controversy among preparers, users, governments and, broadly, all constituencies of the International Accounting Standard Board (IASB). The period between November 2009 and the end of the first quarter of 2010 is turning out to be a rather eventful prelude to the IASB's very ambitious aim to replace all of the requirements of IAS 39 during 2010.

The IASB has embarked on the treacherous quest for a clearer, more user-friendly and more US GAAP compatible standard on financial instruments, by committing to a tentative project plan for the replacement of IAS 39. This consists of three main phases:

- > Phase 1: Classification and measurement
- > Phase 2: Impairment methodology
- > Phase 3: Hedge accounting

An immediate, albeit expected, draw-back was suffered by the project when, soon after the IASB was celebrating the publication of IFRS 9, which represented the completion of phase 1 in November 2009, the European Financial Reporting Advisory Group (EFRAG) postponed its endorsement. Notwithstanding that this frustrated the provision of early application in 2009, no indication on whether EFRAG will endorse IFRS 9 before its effective date, or ever, has been given.

Concerning phase 2, the IASB is seeking to obtain an 'expected loss model for impairment of financial assets'. The model's feasibility is far from being finalised, however its inputs (including the EFRAG's proposal) have been of great value for the development of the related ED published in November 2009.

Finally, sometime in this current quarter, we can expect an ED on hedge accounting, which would kick start the bulk of operation of phase 3.

We will keep a close eye on this project in future editions and welcome your comments and impressions on this matter.

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



Joseph Ellul Falzon Management Commentary

Milestones

Objectives:

- To prescribe a framework aimed at assisting management in preparing and presenting management commentary to accompany financial statements prepared in accordance with IFRS

Current status:

- ED/2009/6 Management Commentary issued on 23 June 2009

What's next:

- The comment period on this ED closes on 1 March 2010. Final guidance document (not a Standard) is expected to be issued in the second half of 2010.

On 23 June 2009, while most of us were gradually allowing our thoughts to turn to suntan lotions and warm golden sands, the International Accounting Standards Board (IASB) quietly announced the arrival of ED/2009/6 Management Commentary. The exposure draft proposes non-mandatory guidance to assist management in preparing decision-useful commentary to accompany financial statements prepared in accordance with International Financial Reporting Standards (IFRS).

In a relatively unorthodox manner, this project will not culminate in the issuance of a new IFRS. Accordingly, it would not be a requirement for an entity to comply with the framework for the preparation and presentation of management commentary as a condition for asserting compliance with IFRS. The proposals in the exposure draft are in fact intended to provide a basis for the development of good practice in preparing management commentary (sometimes called 'management's discussion and analysis' or 'operating and financial review'), and, effectively, will provide a non-binding framework that could be adapted to the particular circumstances of differing jurisdictions. Indeed, although the draft has been developed with publicly traded entities in mind, it does not mandate which entities should be required to publish management commentary, how frequently they should do so and the level of assurance to which published management commentary should be subject.

The content elements of management commentaries are likely to vary from one entity to another, not least because of the differing economic realities to which different entities are subject. However, such commentaries are likely to include information that would assist the user in understanding the nature of the business, management's objectives and strategies, the entity's most significant resources, risks and relationships, its results and prospects and critical performance indicators used by management in assessing performance.

The exposure draft builds upon the assumption that, generally, information that is important to management in managing its business (including information that assists in the assessment of an entity's financial performance and future aspirations) is equally important to users of financial reports. Within this context, management should consider the needs of the primary users of financial reports (being existing and potential capital providers) before deciding what information to include in their commentary. This decision should result in the provision of information that in turn could assist users to place the related financial statements in context. Particularly, such commentary would extend beyond the somewhat typical analysis of past performance, to management's assessment of present day operations and, perhaps more significantly, its outlook on the future. In doing so, management commentary would highlight the entity's goals and strategies, and assess the extent to which past performance is indicative of future results. Moreover, management should seek both to supplement and complement financial statements, by presenting additional information about the circumstances that helped shape the financial statements and by presenting information (not necessarily financial) that is not presented in the financial statements themselves.

With respect to presentation, the exposure draft highlights the importance of clarity and straightforwardness. Commentary should focus only on information that is useful, with such usefulness necessarily reflecting the fundamental qualitative characteristics of relevance and faithful representation and the maximisation of the enhancing qualitative characteristics of comparability, verifiability, timeliness and understandability. The IASB believes that providing non-mandatory guidance will improve consistency and the comparability of management commentary across jurisdictions.

Joseph is Head of Assurance in RSM Malta
T: +356 2149 3313
E: joseph.ellul.falzon@rsmmalta.com.mt



Francesco Bellandi

The Other Comprehensive Income Dilemma

1 Items of other comprehensive income

Both the 2007 Revision of IAS 1 and FASB Statement No. 130 define other comprehensive income similarly, as the set of items of income and expense (revenue, expenses, gains and losses, under US GAAP) that are not recognised in profit or loss (and that are included in comprehensive income but excluded from net income, under US GAAP)¹. Income and expense recognised directly in equity is the expression under IFRS that has long been the substantial equivalent to other comprehensive income under US GAAP, although such a phrase is generally applied to single items and not to the whole set of those income and expenses.

However, neither IFRS nor US GAAP have a general theory of other comprehensive income and recycling (or reclassification, under IFRS)². The concepts of comprehensive income and other comprehensive income are not part of the IASB Framework. Recycling is not mentioned in the US Concepts or IASB Framework³.

US GAAP does not provide an inventory of items as part of the definition of other comprehensive income, but it simply states certain items as examples of existing pronouncements on the subject⁴.

The 2007 Revision of IAS 1, unlike the previous one, lists the items of other comprehensive income as: (i) changes in revaluation surplus, (ii) actuarial gains and losses on defined benefit plans when their recognition in the statement of comprehensive income is elected, (iii) currency translation adjustment, (iv) unrealised gains or losses on available-for-sale financial assets, (v) unrealised gains and losses on hedging instruments in a cash flow hedge⁵ and, recently, (vi) gains and losses from investments in equity instruments measured at fair value through other comprehensive income⁶.

Although, as mentioned in IFRIC 17, the fact that IAS 1 lists items of other comprehensive income prevents applying them by analogy⁷, this listing is not comprehensive, as other items are part of other comprehensive income (or, better, there are several variants).

Exhibit 1 classifies components of other comprehensive income under U.S. GAAP and IFRS according to whether or not they are recycled and what methods are employed for recycling. Detailed explanations about each of the items can be found in *F. Bellandi, Accounting for Equity and Other Comprehensive Income: Dual Reporting Under US GAAP and IFRS*⁸, Sapienza State University Press, 2009.

2 Display of other comprehensive income

Exhibit 1

<u>IFRSs</u>	<u>U.S. GAAP</u>
<u>OCI Items recycled through profit or loss</u>	
<ul style="list-style-type: none"> • 5 items: under IAS 1 (2003) as a separate component, but no statement was mentioned • 7 items: under IAS 1 (2003) a statement was mentioned • 1 item: transferred to the initial carrying amount of the hedged item and then indirectly recycled 	<ul style="list-style-type: none"> • 13 items: in other comprehensive income, with FAS 130 display alternatives
<u>OCI Items not recycled</u>	
<ul style="list-style-type: none"> • 2 items 	<ul style="list-style-type: none"> • 2 items
<u>Transferred directly to retained earnings</u>	
<ul style="list-style-type: none"> • 1 item: recognized directly in the statement of comprehensive income with immediate transfer to retained earnings • 4 items: subsequent transfer to retained earnings • 4 items: transfer to retained earnings based on transitional provisions 	<ul style="list-style-type: none"> • 4 items: transfer to retained earnings based on transitional provisions
<u>Involving multiple components</u>	
<ul style="list-style-type: none"> • 3 items 	<ul style="list-style-type: none"> • 2 items

Under FASB Statement No. 130, a specific statement of comprehensive income, a statement of income and comprehensive income or the statement of changes in equity are allowed as alternatives for reporting comprehensive income and OCI. Under the 2007 Revision of IAS 1, individual items of income and expense must be presented either in the statement of comprehensive income, or in a separate income statement up to profit or loss and in an additional statement of comprehensive income up to comprehensive income (the so-called two-statement approach), but not in the statement of changes in equity⁹.

For foreign private issuers in the USA, Form 20-F accepts one of the options allowed by FASB Statement No. 130 for both Item 17 and Item 18, using either US GAAP or home-country GAAP. In any case, a statement is required. Reconciliation to US GAAP is encouraged but not required to a registrant presenting comprehensive income under local GAAP. Under FASB Statement No. 130, accumulated other comprehensive income must be displayed separately from both retained earnings and additional paid-in capital on the equity section of the statement of financial position.

Exhibit 2.1

	U.S. GAAP				
	Statement of CI	Statement of Income & CI	SOCIE	Notes	Balance Sheet
Total AOCI (1)			Or		And, separately
Beginning and ending amount of each item in AOCI, classified based on nature (2)			Or	Or	Or
Each item of OCI arising in the period	Or	Or	Or		
Total OCI arising in the period	In the statement where OCI is shown				
Reclassification adjustments, if gross display	In the statement where OCI is shown				
Reclassification adjustments, if net display	Netted with the current-period G/L, in the statement where OCI is shown			Detail	
Income tax related to OCI, gross display	In the statement where OCI is shown. Tax shown as a single line			Detail	
Income tax related to OCI, net display	In the statement where OCI is displayed, OCI components are shown net			Detail	
Total net income (3)	Or	Or	Or		As part of retained earnings
Total CI (4)	In the statement where OCI is shown				Not required, but not prohibited

G/L: gains or losses. CI: comprehensive income. OCI: other comprehensive income. (1) AOCI: accumulated other comprehensive income. (2) Not required under Item 17 of Form 20-F for foreign issuers. (3) If other comprehensive income items exist, net income must be shown as a component of comprehensive income. (4) In absence of other items of other comprehensive income, an enterprise need not report comprehensive income.

Exhibit 2.2

	IFRSs (*)				
	Statement of CI	Statement of Income & CI	SOCIE	Notes	Balance Sheet
Total AOCI (1)			Or (2)	Or (2) (3)	Or (2) (3)
Beginning and ending amount of each item in AOCI, classified based on nature (accumulated balance of each class of other comprehensive income)			Yes (4)		(6)
Each item of OCI arising in the period, by nature	Or (5)	Or (5)	(6)	No	
Total OCI arising in the period	Not required, but not prohibited		No	No	
Reclassification adjustments, if gross display	Yes	Yes	No		
Reclassification adjustments, if net display	Netted with current-period G/L		No	Detail	
Income tax related to OCI, if gross display	OCI components shown gross Tax shown as a single line		No	Detail	
Income tax related to OCI, if net display	OCI components shown net		No	Detail	
Total net income (profit or loss for the period)	Yes	Yes	No		As part of RE
Total CI (7)	Yes	Yes	Yes		Segregated between RE and other reserves

(*) IFRSs terminology is in brackets if different from that of U.S. GAAP. SCI: statement of comprehensive income. SOCIE: statement of changes in shareholders' equity. G/L: gains or losses. CI: comprehensive income. OCI: other comprehensive income. AOC I: accumulated other comprehensive income.

Note to Exhibits 2.1 and 2.2

- (1) IFRSs use the expression "accumulated balance of each class of other comprehensive income".
- (2) Description of the nature and purpose of each reserve within equity is required (IAS 1 Revised 2007, Para. 79(b)).
- (3) In addition, disclosure is permitted as subclassification (IAS 1 Revised 2007, Para. 78(e)).
- (4) Also including separate disclosure of period changes (IAS 1 Revised 2007, Para. 106(d), 108). IAS 21 requires the presentation of gains or losses on foreign currency translation in other comprehensive income and of the cumulative amount as a separate component of equity.
- (5) IAS 1 also requires the separate display of the share of the other comprehensive income of associates and joint ventures accounted for by using the equity method.
- (6) The amendments by the 2008 Revision of IAS 27 require the display of the beginning and ending balances and period changes in each component of equity that result from both profit or loss and each item of other comprehensive income.
- (7) Showing separately total amounts attributable to equity holders of the parent and to non-controlling interest.

This is not required under Item 17 of Form 20-F. However, effective for fiscal years ending on or after 15 December 2011, all issuers will have to comply with Item 18 rather than Item 17. Furthermore, the SEC Staff clarified that a foreign private issuer that under local GAAP reports items of accumulated other comprehensive income in retained earnings is exempted from reclassifying the components of accumulated other comprehensive income in case this reconstruction is impracticable and it discloses this fact¹⁰. Under the Discussion Paper of the Financial Statement Presentation Project the single statement of comprehensive income would remain the only format¹¹. **Exhibits 2.1 and 2.2** summarise the minimum display requirements under IFRS and US GAAP for each presentation alternative.

3. Purpose of other comprehensive income

Notwithstanding the lack of a theory of other comprehensive income, a conceptualisation is possible of the main characteristics that are generally associated with other comprehensive income along different hypotheses, i.e. the realisation hypothesis, defence of capital, fair value measurement, anticipatory value, measurement base difference, recognition timing difference, volatility and the entity's performance hypotheses. Refer to *F. Bellandi (2009)* for this conceptualisation.

4. The other comprehensive income dilemma

Other comprehensive income has some pros, but can its cons be avoided? Should net income or comprehensive income be intended as a measure of performance? Should a double statement of income or a subtotal for net income exist in a single statement of comprehensive income? Has recycling a conceptual purpose? Not to mention certain unintended consequences due to equity restrictions for defence of capital in civil law jurisdictions.

At least five possible conceptual solutions to the dilemma can be identified. Firstly, alternative recognition models, i.e. immediate recognition in profit or loss would eliminate OCI. The IASB found immediate recognition tempting¹². However, this has some pros and cons and it would have serious implications, such as the elimination of cash flow hedge accounting.

Secondly, other comprehensive income and recycling would not exist if a single measurement basis were used. However, as examples, the conceptual difference between trading and available-for-sale securities would blur and the method for foreign currency translation adjustment would change. CON 5 (Statement of financial accounting concept number 5: 'recognition and measurement in

financial statements of business enterprises') chooses a model of multiple measurement attributes. A mixed measurement model assumes that all individual financial statements have the same or similar prominence and the basis that is most representationally faithful may differ depending on items. Under this approach, the best measurement attribute depends on its reliability and the nature of the item measured¹³. Furthermore, recognition and measurement fall outside the scope of the Financial Statement Presentation Project.

The use of alternative presentation models may be a third solution. Under this theory, other comprehensive income is recognised directly in a statement of income, renamed as the statement of comprehensive income, and presented as a separate line or otherwise disclosed. This makes it possible to maintain any existing recognition model and measurement bases. Focus shifts from recycling from the equity section of the statement of financial position to the income statement to "reclassification" from one line to another within the statement of comprehensive income. The dilemma is solved only partially, because two possible indicators of performance still exist. Information content of other comprehensive income and its reclassifications would remain. Multiple recognition and measurement bases model could be maintained. However, somehow inconsistently, amounts that Standards do not allow to be income or expense of the current period influence the display of comprehensive income for the current period. There is no clean-surplus concept of income as accumulated other comprehensive income is a component of equity different from retained earnings. The 2007 Revision of IAS 1 follows a similar approach. This method was selected as a practical solution towards a single statement of comprehensive income, which is one of the objectives of the Financial Statement Presentation Project¹⁴.

A further option may be expanding the approach that IFRS currently follow for revaluation surplus and actuarial gains and losses and for any adjustments arising from the asset ceiling limit on defined benefit plans, i.e. direct transfer to retained earnings. Information content of segregating holding gains and losses would remain. This would eliminate recycling. It would be consistent with the concept that holding gains and losses that are capital maintenance adjustments may not be recycled. However, not all other comprehensive income items are capital maintenance adjustments. With immediate transfer to retained earnings, there would be no need for other comprehensive income or comprehensive income. On the other hand, it would violate the clean-surplus concept of income, as well as the basic principle of retained earnings based on which retained earnings cannot be increased by events or transactions that do not pass through profit or loss.

Finally, another approach joins the model of immediate recognition in the income statement and the simultaneous appropriation of retained earnings (or of the creation of equity reserves) to disclose and restrict the distributability of an amount corresponding to the unrealised, volatile or otherwise unqualified earnings. Once the conditions that currently trigger a recycling occur, appropriated retained earnings would be returned to unappropriated retained earnings or the equity reserve reversed. This is similar to models used by several European local GAAP. From the standpoint of the statement of income, the clean-surplus concept would be maintained, as all items of income and expense go in profit or loss. Unappropriation of retained earnings or reserve reversal would substitute recycling. Therefore, presentation becomes independent of measurement and recognition. Separate disclosure and reclassification on income statement would disclose unrealised, volatile, etc. characteristics or "qualities of earnings". From the perspective of the equity section of the statement of financial position, it would be consistent with the current classification of other comprehensive income as a component of equity reserves under IFRS, it would permit to disclose different "qualities of equity", and all items of profit or loss would transfer to retained earnings. Furthermore, it would accommodate legal restrictions for defence of capital in civil law countries, avoiding certain conflicts with IFRS that lead to jurisdictional versions.

Francesco is a US CPA, Italian CA, ACCADipIFR, MBA, Member of International Accounting & Auditing Committee of the New York State Society of CPAs.

He manages DualGAAP.com, Dual Reporting under US GAAP and IFRS

T: + 39 348 541 7688

E: francesco_bellandi@yahoo.com

Patrick Brown - Comments on OCI

In July 2009, at the joint FASB and IASB financial instrument project meeting, the Boards made a preliminary decision that an entity should present a single statement of comprehensive income. This issue was initially raised during deliberations for the financial statement presentation project, but the Boards decided to address it in a separate project during the near term. Recently at the 27 October 2009 Joint FASB/IASB Board Meeting, the IASB staff discussed the IASB recent decision to amend IAS 1 Presentation of Financial Statements, which requires an entity to present all items of income and expense as a single statement of comprehensive income. The staff also explained the IASB decisions to provide additional guidance on how items reported in other comprehensive income must be presented within the single statement of comprehensive income. In addition, the staff commented that the FASB has made similar decisions during its deliberations in its ongoing projects on Financial Instruments and the joint FASB/IASB project on Financial Statement Presentation. As a result, the IASB staff asked the joint FASB/IASB Boards to consider working together to develop guidance on a single statement of comprehensive income that would be as convergent as possible and would be issued in the near term. The Boards unanimously decided to work together to develop guidance on the preparation of a single statement of comprehensive income that is convergent but would be issued separately by the IASB and FASB. The objective of this joint project is to provide guidance on reporting comprehensive income for all entities. The FASB's goal is to issue a proposed Accounting Standards Update together with the proposed Update for financial instruments at the end of the first quarter of 2010.

Patrick is a Partner of McGladrey & Pullen LLP

E: patrick.brown@rsmi.com

Sources

¹FASB Statement No. 130, ¶ 10; IAS 1 (Revised 2007), ¶ 7.

²IAS 19, Basis for Conclusions, ¶ 48P.

³FASB/IASB Financial Statement Presentation Project, Agenda Paper 6C/FASB Memorandum 44C, Measurement; OCI and Recycling; the Statement of Comprehensive Income, ¶ 44 (October 24, 2006) <www.iasb.org>.

⁴FASB Statement No. 130, ¶ 39 (FASB ASC 220-10-55-2)

⁵IAS 1 (Revised 2007), ¶ 7.

⁶IFRS 9, Financial Instruments, ¶ C12 (November 2009).

⁷IFRIC 17, ¶ BC48.

⁸Available at <http://digital.casalini.it/editori/default.asp?isbn=9788895814261&tipologia=M> or http://www.dualgaap.com/main.php?rid=eservice_product_zoom&fld_id=12. This article is a condensed and adapted excerpt from a section of the Book, with permission. All rights are reserved.

⁹IAS 1 (Revised 2007), ¶¶ 81, BC53.

¹⁰FASB Statement No. 130, ¶ 26 (FASB ASC 220-10-45-14); U.S. Securities and Exchange Commission, International Reporting and Disclosure Issues in the Division of Corporate Finance, ¶ VI.A (November 1, 2004); US Securities and Exchange Commission, Release No. 33-8959, Foreign Issuer Reporting Enhancements, ¶ I.I.E (December 2008).

¹¹Discussion Paper, Preliminary Views on Financial Statement Presentation, ¶¶ 3.28, 3.29, 3.31, 3.87 (October 2008).

¹²IAS 19, Basis for Conclusions, ¶¶ 41, 46(a).

¹³CON 5, ¶¶ 66, 70.

¹⁴IASB Update, July 2002.



KC Rottok

Auditing Impairment Tests During a Recession

During poor economic times, management of various companies may be under pressure to produce good results and may use various means to justify the fair value of goodwill and indefinite life intangible assets. In these circumstances, the auditor should proceed with scepticism and caution when reviewing the impairment test prepared by management for these elements of the financial statements.

Things to look out for

Classification

Due to the very subjective and somewhat complex nature of all intangibles, management is able to adopt different strategies in classifying an asset so as to enhance the overall profitability of the company. For example, during the purchase price allocation [see next section] of a business combination, management may regard intangible assets as having an indefinite rather than a finite life, since the latter classification would require an annual charge through the statement of profit and loss that may not attract a corresponding tax deduction.

Discount Rate

Another trick auditors should be wary of is what principles management uses in determining the discount rate. The lower the discount rate used in a discounted cash flow calculation, the higher the net present value result and, therefore, the lower the chances of impairing the goodwill. The auditor should check that the principles used in arriving at the discount rate are sound and that the rate used has not been assumed simply because it produces a favourable result. IAS 36 requires the use of a discount rate that reflects current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted. Whereas this may be the current borrowing rate or a weighted average cost of capital, a change in the methodology in a subsequent impairment test may be a dishonest attempt to avoid recognising an impairment. For example, where a company is faced with different levels of debt, management may suddenly prefer to use the current very low prime interest rate as the overall cost of debt to the company, resulting in a higher valuation, see **Exhibit 1**. This is because weighting the different costs of debt which they would have done previously would be likely to produce a higher number. The auditor should ensure that consistency in the method of arriving at the discount rate is maintained.

Cash Flow Projections

The cash flow projections prepared by management is perhaps the area where auditors need the most vigilance when reviewing the impairment test. For example, a company's management may have two different budgets, one presented to the auditor for purposes of reviewing the impairment test and evaluating going concern and an entirely different one used for internal management. This would be the case where it is difficult for management to produce a single forecast that is low enough to be achieved so as to impress their superiors, but high enough to be used in a cash flow calculation that escapes an impairment charge. That said, it is possible to have different cash flow projections depending on their purpose. This is because for internal management purposes management uses its own view and not that of market participants. In addition, such expenses as restructuring costs and the effect of future not yet committed capital enhancements may not be included in the calculation for impairment testing, but may be useful for management's internal projections. However, certain elements of the projection used for impairment testing should indicate no variation from other budgets such as the value of sales or the gross profit margin. The auditor should ensure that these important elements in the projection used have been approved by the Board or relevant level of management.

Allocation of Goodwill

Goodwill is initially allocated during the Purchase Price Allocation phase at the inception of the business combination. IAS 36 states that goodwill should be allocated to cash generating units that represent the lowest level at which goodwill is monitored for internal management and not larger than an operating segment. Due to this statement, it has been noted that some companies aggregate goodwill into large units for testing, justifying this as the lowest level for which it is monitored for internal management. In the article "The Failure of IFRS 3" - IAM 2007, Thayne Forbes' findings indicate that such aggregation can include parts of the acquirer's existing business so as to minimise the risk of impairment. A company with a small division that is battling to break even may include this division in an impairment test of a large stable cash generating unit. As a result, no impairment is duly recognised on the associated goodwill of this division which is technically a separate cash generating unit as defined in IAS 36. To avoid such manipulation of the impairment testing process, the auditor should insist on separate discounted cash flow calculations for each cash generating unit, particularly those that have indications of impairment.

Why take the High Road?

It is mandatory for an auditor to know the business of the client well enough to have an indication of whether or not the cash flow projections are too ambitious given the current macro-economic environment. This is due to the requirements of the International Standards of Auditing, in particular ISA 315, which requires an auditor to understand the entity and its environment, including the objectives, strategies and the related business risks that may result in a material misstatement of the financial statements. One way for the auditor to achieve this, is to review the management accounts of the entity after year end and to document the entity's performance to corroborate the assumptions used in the impairment test calculation.

It is also in the best interests of management to be as accurate as possible when performing impairment tests. An inaccurate impairment test could easily be argued to constitute fraudulent financial reporting, which is currently an offence in most jurisdictions. In addition, for example in South Africa, the new Companies Act 2008 prescribes extremely high fines and a jail term of up to 10 years for all persons that are party to the preparation of financial statements that are materially false or misleading.

Both the auditor and management would be short-sighted in accepting an impairment test calculation that is flawed. In ensuing financial years, if the entity fails to meet the cash flow projections, higher impairment charges will be recognised in subsequent financial statements as opposed to the systematic expensing of the impairment. Worse still, in terms of IAS 8, it may be more accurate to recognise a prior year error for the value of goodwill previously reported in the financial statements. This Standard defines an error as a misstatement arising from a failure to use reliable information that was available at the time and could reasonably be expected to have been taken into account.

Small and Medium Enterprises

The IASB has recently issued the Statement "IFRS for Small and Medium Enterprises (SMEs)". The statement applies to entities that have no public accountability. Such SMEs are in many instances owner managed which reduces the incentive to skew results. However, the need to show profitable results may

still exist, such as where the SME requires external financing. Whereas this new Statement requires the amortisation of goodwill, it should not be forgotten that it also stipulates that goodwill must be tested for impairment where there are indications that it might be impaired. The auditor and management should be careful to look out for such indications of impairment, particularly in these difficult times.

Conclusion

When businesses are doing well, the performance of an impairment test usually takes the form of a routine exercise that concludes that goodwill and indefinite life intangible assets should remain at their current balance sheet levels. In practice, the process of impairment testing has been found to be less rigorous where both management and the auditor do not consider the impairment of goodwill to be a risk. Management should adopt uniform principles that comply with both auditing and accounting standards which should be applied consistently to impairment testing irrespective of the prevailing conditions. These standards were prepared after extensive deliberation and will therefore be useful in producing reliable financial statements that reflect a fair and reasonable value of all intangible assets.

Exhibit 1

A company with negligible equity may have a cash generating unit with three loans, the first CU1500 with a fixed interest rate of 15%, the second CU500 also at a fixed rate of 15% and the third CU 1000 at an interest rate of the prime lending rate minus 1%. Assuming a prime lending rate of 11%, if this is advanced by the company as its cost of debt, a cashflow of CU 1500 in five years time will have a present value of CU918. If one takes the trouble to calculate the actual weighted average cost of debt, it would be found that this is 13.33% and the CU1500 in 5 years time amounts to CU830 present value. The difference of CU88 and other present value differences in other periods can cumulatively be the difference between cash generating unit being found to be impaired and being declared fairly valued.

KC Rottok is a Partner - Technical Advisory
RSM Betty & Dickson, South Africa
T: +27 11 329 6000
E: kc.chesaina@jhb.rsmbd.co.za



Jude Doliente

Credit Risk in Liability Measurement

Introduction

In June 2009, the International Accounting Standards Board (IASB) published a Discussion Paper (DP) Credit Risk in Liability Measurement and accompanying IASB Staff Paper in order to solicit comments which were due by 1 September 2009. The DP addresses the role of credit risk in the measurement of an entity's liabilities, referred to as "own credit risk".

Discussions of credit risk in liability measurement have already been included in the IASB's previous consultative documents which include Fair Value Measurement, Preliminary Views on Insurance Contracts, Preliminary Views on Amendments to IAS 19 Employee Benefits and Reducing Complexity in Reporting Financial Instruments. Many of the comments received to these documents have been against proposals to include the effects of credit risk in liability measurements. However, the IASB believes that this current discussion paper, which solely focuses on the role of credit risk in liability measurement, will benefit the standard-setting process.

Whilst the DP solicited comments on various issues, the central questions addressed were:

- > whether or not current liability measurements (including fair value), both at initial recognition and subsequent measurement, incorporate the chance that an entity will fail to perform as required
- > if not, what the alternatives are.

For a better understanding of the implication of incorporating credit risk in liability measurement, consider the following example of a simple entity with one asset and one liability. Assume that between 31 December 2008 and 31 December 2009 all variables are held constant (including the asset value) except the entity's credit standing, which has been downgraded. Further assume that the effect of this downgrade in the present value calculation of the liability is a reduction of 100. The statements of financial positions of the entity might look like this:

	Financial position at 31.12.08	Financial position at 31.12.09
Asset	1,000	1,000
Liability	(700)	(600)
Equity	(300)	(400)*

* initial equity plus gain from remeasuring liability

On balance, when liability measurements include credit risk, an entity reports a gain from a decline in the credit quality of its liabilities. Conversely, a loss is reported when credit quality improves.

Arguments

In order to enhance the debate, the DP included an even-handed presentation of the oft-cited arguments supporting and opposing the proposal of incorporating credit risk in liability measurement. These arguments are summarised as follows:

Arguments	
Supporting	Opposing
Consistency at initial recognition	Counter-intuitive results
Wealth transfer	Accounting mismatch*
Accounting mismatch*	Realisation

*Same line of argument turned in the other direction

Supporting arguments

Consistency at initial recognition

At the initial measurement of a liability incurred in an exchange for cash, the effects of the borrower's credit risk are considered. Hence, by consistency, subsequent current measurements should include the change in the credit risk which was considered at initial recognition.

Wealth transfer

As the entity's ability to pay its liabilities diminishes, equity holders are not required to make additional investments while liability holders have the prospect of sustaining a loss. The loss of the liability holder becomes a gain for the equity holder in the form of a wealth transfer.

Accounting mismatch

If an entity's assets are measured at fair value, changes in credit spreads on those assets will affect their fair value and either profit or loss or other comprehensive income. If the same treatment is not made to the measurement of liabilities, an accounting mismatch results.

Opposing arguments

Counter-intuitive results

When liability measurement includes credit risk, an entity reports a gain from a decline in the credit quality of its liabilities. This gain is counter-intuitive and is potentially misleading since gains should result from improvements in an entity's financial position, not declines.

Accounting mismatch

A decline in credit quality is indicative of some deterioration in the value of assets that may not be measured on a current basis (e.g. fixed assets and goodwill). Because changes on these assets are not recognised in the financial statements, changes in credit quality should similarly be excluded. Doing otherwise results in an accounting mismatch.

Realisation

Fair value accounting for assets is supported by the observation that realisation is not a critical event since assets are easily sold and transferred. The same is not true for liabilities since their transfer usually requires permission of the counterparty or their transfer cannot be done in a practical way.

A viewpoint

The arguments supporting the incorporation of credit risk in liability measurement appear to have theoretical grounding. On the other hand, the opposing arguments have strong merits from the practical standpoint. Hence, our view will reflect a value judgment that strikes a balance between conceptual soundness and practicality.

In our view, the question of whether or not a liability's credit risk should be incorporated in its measurement at initial recognition and subsequent accounting will depend on the type of liability. To recall, there are two types of liabilities: (1) financial and (2) non-financial. Broadly speaking, the distinguishing feature between the two is that financial liabilities represent a contractual obligation to deliver cash or another financial asset to another entity (e.g. bonds) while non-financial liabilities do not (e.g. warranty provision). Our views are summarised as follows:

Liability type	Incorporate credit risk	
	Initial recognition	Subsequent measurement
Financial Trading liabilities*	Yes	Yes
Other financial liabilities	Yes	No
Non-financial liabilities	No	No

* Effect of the credit risk changes in value through Profit and Loss

Initial recognition

On initial recognition, the role of credit risk is considered when measuring financial liabilities as they normally occur in arm's length transactions whereby some form of consideration has been exchanged. The determination of the amount of the consideration can be presumed to have incorporated the credit risk of the obligor in the transaction. Thus, when a bond is issued, its initial price is reflective of the credit risk of the issuing entity.

Measurement of non-financial liabilities upon initial recognition need not incorporate credit risk because these liabilities are entered into by an entity with the view of performing them in accordance with the contractual terms. Hence, if the risk of non-performance is not considered, why measure them? Furthermore, non-financial liabilities generally do not arise from an arm's length transaction in which some form of consideration is exchanged. Hence, absent the consideration, it is not likely that credit risk was objectively considered when the initial liability was priced.

Subsequent measurement

In subsequent measurements of financial liabilities, credit risk changes may be considered in limited cases if the liability is held for trading. The reason for this is that if the liability is held for trading, then the intent of the company is to realise short-term gains and losses arising from changes in market conditions, including the credit risk of the entity. Further, given the complications inherent in determining credit risk, it necessitates that an objective basis for the subsequent measurement of the liability due to changes in credit risk must exist. This basis is evident in a quoted market price for which the entity has the ability to realise the change in value due to the fluctuation in credit risk. The effects of these changes are to be reflected in the income statement.

2 The point of view of ...

The subsequent measurement of other financial liabilities need not consider credit risk as this will not produce decision-useful information. We acknowledge that there is no clear conceptual support for this position other than the observation that non-trading financial liabilities are generally entered into for purposes other than realising short-term gains and losses due to market condition changes. For example, an entity issuing long-term bonds can be presumed to have done so with the intent of funding fixed asset investments and not to obtain profits from changes on the fair valuation of the bond.

For the case of non-financial liabilities, the effects of credit risk need not be incorporated on their subsequent measurement. This treatment is consistent with their initial recognition.

Concluding Comments

Observable in our expressed views is that the incorporation of credit risk in liability measurement subsequent to initial recognition can occur only in very limited circumstances. This is consistent with our notion that liabilities are generally incurred by entities with the intent of settling them in full and not to take advantage of fluctuations in fair value due to changes in credit risk. Furthermore, given that credit risk is not directly observable, remeasuring liabilities due to changes in this variable may not be always practicable when juxtaposed to the limited decision-usefulness of the resultant information.

As a final point, it is our view that an important step in addressing the issue of incorporating credit risk in liability measurement is for the IASB to issue specific guidance on what liabilities are measured at fair value or amortised cost, similar to the approach taken in the recently released IFRS 9 for financial assets [see section 1]. This will potentially reduce complications of incorporating credit risk inherent in a liability measurement both at the points of initial recognition and subsequent accounting since this is implied in the fair valuation process.

**Jude Doliente is an Audit Manager
RSM Prince, New Zealand
T: + 64 (9) 379 5324
E: jude.doliente@rsmprince.co.nz**



Stefano Bianchi...

Selects challenging examples from practice:
Purchase Price Allocation

Goodwill's widely encompassing nature makes it the utmost intangible asset of any in the balance sheet. Historically, it appeared in accounting almost as a technical item needed to make the balance sheet balance upon completion of a merger or an acquisition. In Europe, and in the old IAS 22, the view was taken that, being a fixed asset, it had to be amortised, because eventually any merger or acquisition leads to a new entity where the originating ones blend together and disappear. As for the timing of this process, it used to be left to the preparers of the accounts to decide. Different jurisdictions would impose a variety of provisions (i.e. within a range of 20 to 50 years in different European local standards), all equally lacking in strong logical foundation.

Then IFRS provided for goodwill to be impaired (IFRS 3). The twofold underpinning reasons were: (i) convergence with US GAAP and (ii) acknowledgement that goodwill's very nature makes any amortisation plan a wild guessing exercise.

In the last decades, with the economy moving more and more towards services and knowledge focus, and away from pure manufacturing of tangible goods, the amount of intangible unrecognisable assets has dramatically increased. This has led to ever growing goodwill values being raised at each episode of merger or acquisition.

Hence, not only is goodwill representing ever growing components of the balance sheets of companies, but also its effects on balance sheets and income statements are hardly predictable. A partial solution to these problems is represented by allocating part of the purchase price to specific items, which will have their amortisation plans laid out.

However, purchase price allocation may be a challenging exercise and represents the most effective example of accounting having to invoke valuation techniques, under IFRS. In January 2008, the International Accounting Standards Board (the IASB) issued a revised IFRS 3 Business Combinations. In doing so, the Board completed phase II of its business combinations project, and achieved substantial convergence between IFRS and US GAAP on these topics.

Acquisition cost is determined based upon the amount of cash, securities, or other assets exchanged, in connection with the acquisition. Once the acquisition cost is determined, the first step in the allocation process involves estimating the fair value of the tangible assets and liabilities acquired. Once a value has been allocated to the tangible assets, the residual represents the amount allocable to identifiable intangible assets and goodwill. IFRS 3 and SFAS 141(R) provide guidance concerning the recognition of value associated with intangible assets. The specific, identifiable intangibles of a business enterprise depend largely upon the nature of its operations.

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

1. Identifying the intangible assets to value

IFRS provides illustrative examples of items acquired in a business combination that meet the definition of an intangible asset and are therefore recognised separately from goodwill.

IFRS 3 identified five categories as follows:

1. marketing-related intangible assets, e.g. trademarks, trade names, service marks, newspaper mastheads, internet domain names, non-competition agreements
2. customer-related intangible assets, e.g. customer lists, order or production backlogs, customer contracts and customer relationships including non-contractual relationships
3. artistic-related intangible assets, e.g. plays, operas, ballets, books, magazines, newspapers, pictures, photographs
4. contract-based intangible assets, e.g. licensing and royalty agreements, advertising, construction, service or supply agreements, lease agreements, franchise agreements, employment contracts
5. technology-based intangible assets, e.g. patented technology, computer software, unpatented technology (know-how), databases, trade secrets.

Example:

Novartis¹, the Swiss pharmaceutical Group, states the following accounting policy with regards to key intangible assets arising from acquisition: "In-Process Research & Development (IPR&D) is valued as part of the process of allocating an acquisition's purchase price. Other acquired assets in development, such as those related to initial and milestone payments for licensed or acquired compounds, are capitalized as IPR&D intangible assets. This occurs even if uncertainties continue to exist as to whether the R&D projects will ultimately be successful in producing a commercial product."

2. Choosing the correct valuation methodology

In order to arrive at the estimates of value for the intangible assets in this context, the generally accepted approaches to valuation are commonly referred to as (i) market approach, (ii) cost approach, and (iii) income approach. Within each category, a variety of methodologies exists to assist in the estimation of fair value.

(i) Market Approach

Methods within the market approach are used to estimate value through analysis of recent sales of comparable assets. With respect to the valuation of intangible assets, these types of assets often have little guideline sale transaction data available. This is due to the fact that these assets are created over time and are designed to meet the needs of a specific organisation, and are not generally bought or sold separate from the business enterprise.

(ii) Cost Approach

Methods within the cost approach establish the value based on the cost of reproducing or replacing the asset, less depreciation from physical deterioration and functional, technical and economic obsolescence, if present and measurable. The asset-based approach stresses the utility characteristics of the asset. This approach is most useful as a value indicator when the components of the asset are relatively new; however, it fails to capture the economic benefits arising from the ongoing use of the asset over time.

(iii) Income Approach

"Income", as used in the income approach, is a general term that refers to any future benefits that can be quantified in monetary terms. In using this approach, the first step is to make a projection of the total monetary benefits expected to accrue to an investor as a result of the utilisation of the asset. This stream of monetary benefits is then discounted over the entire projection period to arrive at the present value, or value of the asset. This approach focuses on the income producing capability of the acquired asset and, when appropriate, best represents the present value of the future economic benefits expected to be derived from it.

Each of the approaches described above may be used to value the identified intangible assets; however, the appropriateness of these approaches varies with the types of assets being valued and the availability of information. While each of these approaches is initially considered in the valuation of an intangible asset, the nature and characteristics of the intangible asset indicates which approach, or approaches, are most applicable. The valuation approach applied is outlined in the discussion of each of the identified intangible asset valuations.

Example:

GSK, another large pharmaceutical group, in its 2008 financial statements² upon identifying the key intangible assets arising from the acquisition of CNS Inc., has used a discounted cash flow model for their valuation. "On 19th December 2006, the Group acquired 100% of the issued share capital of CNS, Inc., a consumer healthcare company based in the USA for a cash consideration of £280 million. The company markets Breathe Right nasal dilator strips and FiberChoice dietary fibre supplements. These are the key intangible assets acquired and have been valued using a discounted cash flow calculation. This transaction has been accounted for by the purchase method of accounting. The goodwill arising on the acquisition reflects the potential for expansion of the brands into other overseas markets and the expected synergies for the Group. CNS, Inc. had a turnover of £71 million (2005 - £60 million) and a profit of £11 million (2005 - profit £9 million) for 2006 of which £2 million of turnover and £nil of profit related to the period since acquisition and are included in the Group accounts."

3. Determining the fair value adjustment and disclosure

One of the principal drivers behind purchase price allocation (PPA) is to bring greater transparency to the acquisition process in the financial statements, to identify and value the assets being acquired and to arrive at the net residual amount which will be attributed to goodwill. In one of the most significant recent acquisitions, i.e. the acquisition of ABN Amro by Royal Bank of Scotland (RBS) the renowned bank group that was subsequently bailed out by the UK government, the fair value adjustments identified were about £3.9bn compared to £48.6bn of consideration. As reported in RBS 2008 financial statements: "On 17 October 2007, the Group, through its subsidiary RFS Holdings B.V. ('RFS'), acquired 99% of the ordinary shares of ABN AMRO Holding N.V., the holding company of a major European banking group based in the Netherlands with subsidiaries that undertake commercial banking operations, investment banking and other related financial activities. The provisional fair values of ABN AMRO's assets and liabilities at the date of acquisition and the consideration paid were as follows:"

	Pre-acquisition carrying amounts £m	Disposal groups £m	Provisional fair value adjustments £m	Recognised acquisition values £m
Cash and balances at central banks	7,263	(186)	-	7,077
Loans and advances to banks	120,120	(3,646)	-	116,474
Loans and advances to customers	314,287	(26,158)	(1,843)	286,286
Treasury and other eligible bills and debt and equity securities	166,018	(3,804)	-	162,214
Derivatives	86,695	(322)	-	86,373
Intangible assets	4,239	(3,522)	4,282	4,999
Property, plant and equipment	2,062	(747)	175	1,490
Other assets	32,710	(7)	1,357	34,060
Assets of disposal groups	2,987	38,392	787	42,166
Deposits by banks	(160,906)	2,808	(321)	(158,419)
Customers accounts	(253,583)	13,786	(152)	(239,949)
Debt securities in issue	(134,630)	5,937	776	(127,917)
Settlement balances and short positions	(44,748)	36	-	(44,712)
Derivatives	(85,491)	417	-	(85,074)
Subordinated liabilities	(11,748)	868	685	(10,195)
Other liabilities	(21,268)	271	(1,814)	(22,811)
Liabilities of disposal groups	(2,377)	(24,123)	-	(26,500)
Net identifiable assets and liabilities	21,630	-	3,932	25,562
Minority interests				(242)
Goodwill on acquisition				23,255
Consideration				48,575

4. Estimation of future cash-flows

Cash flow projections are often the base of the valuation if the income approach is utilised. In this case management must assess the reasonableness of the assumptions used as the basis for the current cash flow projections and give greater weight to assumptions supported by external market data. The cash flow projections must be based on the most recent financial budgets that have been approved by management [See KC Rottok article in the previous section].

The most popular model used is the DCF - Discounted Cash Flows - with a 5-year period. However, the model is often pushed to a longer period (e.g. 10 years). Novartis, in its 2008 financial statements, indicates that *"If no cash flow projections for the whole useful life of an intangible asset are available, we utilize cash flow projections for a five-year period based on management forecasts, with a terminal value based on sales projections usually in line or lower than inflation rates for later periods"*.

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

Sources

- 1 Novartis Group Annual Report 2008, page 156
- 2 GSK Annual Report 2008, page 153
- 3 RBS Group • Annual Report and Accounts 2007, page 203

RSM International

global excellence in audit, tax & consulting

Global Contacts

Americas

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

Middle East

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

Europe

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

Africa

Louis Quintal
T: +27 11 329 6000
E: louis.quintal@jhb.rsmbd.co.za

Asia Pacific

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

RSM Global Executive Office - UK

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

Guest Contributor: Francesco Bellandi

Francesco Bellandi is author of the book: Accounting for Equity and Other Comprehensive Income: Dual Reporting under U.S. GAAP and IFRSs, Sapienza Rome State University Press, 2009, available on-line at www.dualgaap.com.

Francesco, US CPA (Certified Public Accountant), Dottore Commercialista (Italian Certified Accountant), Diploma in International Financial Reporting of the ACCA (The Association Of Chartered Certified Accountants, UK); MBA, SDA Bocconi School of Business, Bocconi University; Degree in Economics, LUISS University; Diploma in Private Equity of the AIFI (Italy's private equity association) is a practitioner in US GAAP/IFRSs Dual Reporting. He is a member of the AICPA, the NYSSCPA's International Accounting & Auditing Committee, the North Dakota State Society of Certified Public Accountants, and ANDAF (Italian association of finance directors). He has served as a Board Director and Chief Financial Officer in Cobalt Waterline Group (2007-2008); Director Finance & Administration in Alitalia Maintenance Systems (Alitalia - Lufthansa Technik) (2003-2005); Chief Financial Officer in Alitalia North America & Mexico, New York (2001-2003); Director Business Planning & Finance Performance SEMEA Southern Europe, Middle East, and Africa in Société Internationale de Télécommunications Aéronautiques (1999-2001); Manager Finance & Administration/Shared Services, Reengineering & Restructuring in Ernst & Young (1997-1998); Financial Controller and Logistics Manager in Ericsson (1993-1997); Financial Analyst in IRI (1988-1992).

E: francesco_bellandi@yahoo.com

Editor

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

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