IFRS Top 20 Tracker

2010 edition

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Introduction

Top 20 Tracker – 2010 edition

The 2010 edition of the Top 20 Tracker continues to take management through the top 20 disclosure and accounting issues identified by Grant Thornton International Limited (Grant Thornton International) as potential challenges for IFRS preparers. The member firms within Grant Thornton International - one of the world's leading organisations of independently owned and managed accounting and consulting firms - have extensive experience in the application of IFRS. Grant Thornton International, through its IFRS team, develops general guidance that supports its member firms' commitment to high quality, consistent application of IFRS.

This edition is based on IFRS applicable for accounting periods commencing on or after 1 January 2009.

Key themes driving selection of the issues in the 2010 edition are:

- the continued impact of the global financial crisis, with economic and market conditions remaining difficult in many areas of the world
- areas of focus for regulators with responsibility for enforcement of financial reporting requirements
- more recent changes to Standards and Interpretations, which affect both first-time adopters and companies already reporting under IFRS.

The Tracker is not of course intended to be a comprehensive list of issues that companies may face during this financial reporting season. It is intended to highlight some of the key issues that clients of the member firms within Grant Thornton International are having to deal with currently and provide a reference for management to help them focus on these matters.

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1 Highlights of the key issues

1.1 Economic situation

Economic conditions remain challenging in many areas of the world. For companies operating in those countries, clear communication of any uncertainties relating to going concern and of management's judgements in reaching a conclusion on the company's going concern status is vital (Section 4).

Impairment write-downs may be required against goodwill, other intangible assets or even property, plant and equipment, due to downward revisions of cash flow forecasts for the business or cash-generating unit involved (Section 9).

In some countries, tightened credit-granting policies of banks are giving rise to additional challenges for what would normally be routine renewals of bank facilities. Asset write-downs in those countries are putting pressure on covenant compliance. Covenant breaches may necessitate reclassifying liabilities as current (Section 12).

Economic conditions may also have an impact on employee benefits. Many companies are closing defined benefit schemes or incurring significant restructuring and redundancy costs (Section 16).

1.2 Regulators' key areas of interest

Good disclosure of management's key judgements in applying accounting policies and key sources of estimation uncertainty is essential to enabling readers of the accounts to understand the basis on which they have been prepared (Section 3).

Accounting for acquisitions gives rise to many accounting challenges. Regulators are likely to question companies where they cannot follow the accounting or believe disclosures are inadequate (Section 6).

Revenue recognition policies continue to be under scrutiny, and have been highlighted by economic difficulties in some areas of the world. Recent clarification of requirements regarding real estate construction also needs to be considered (Section 7).

Changes to segmental reporting disclosures for 2009 will be a key area of focus for regulators, who have already highlighted some concerns (Section 8).

IFRS requirements on capital disclosures are often overlooked. Again, challenging economic conditions in some areas have highlighted the need for good disclosure in this respect (Section 17).

Finally, regulators can raise questions on many other areas of companies' financial statements so getting the detail right matters (Section 20).

1.3 Problem accounting areas

Compliance with foreign currency translation requirements continues to present a significant challenge for many companies, highlighted by the fluctuations in currency movements over the last year (Section 11).

Discounted cash flow techniques are used widely under IFRS. Determining appropriate discount rates is essential. The underlying assumptions and estimates need to be explained properly (Section 13).

Deferred tax assets may no longer be supported by expected future profits. Offsetting deferred tax assets and liabilities is subject to strict rules under IFRS (Section 14).

1.4 Recent changes in financial reporting

There have been significant changes to presentation requirements for the financial statements, giving rise to new challenges in complying with IFRS requirements (Section 2).

Financial instruments disclosures have also changed, in particular those relating to fair values and liquidity risk (Section 10).

Changes to accounting requirements for share-based payments may require retrospective restatement. Economic conditions in some countries may also impact on share-based payment accounting (Section 15).

Amendments have been made to IFRS 1 'First-time Adoption of International Financial Reporting Standards'. The amendments introduce additional exemptions from the normal requirements of IFRS, and will be of interest to the many companies that will be adopting IFRS for the first time in the near future. The amendments address impediments to the adoption of IFRS in certain jurisdictions, and aim to offer a pragmatic solution to them that will reduce the costs for first-time adopters (Section 18).

The IASB has also reached the end of the first stage of its three-phase project to replace IAS 39 *Financial Instruments: Recognition and Measurement*, with the publication of IFRS 9 *Financial Instruments*. Companies need to be aware of the requirements of the new Standard and the advantages and disadvantages associated with adopting it early (Section 5).

More generally, changes to Standards are on the way for 2010 and beyond (Section 19).

2 Presentation of financial statements under IAS 1 (revised 2007)

2.1 Statement of comprehensive income

IAS 1 (Revised 2007) *Presentation of Financial Statements* applies to periods beginning on or after 1 January 2009. Amongst other things, it changes the presentation of the primary statements.

One of the main changes is that entities must now present a statement of comprehensive income, and have the choice as to whether to present this as one statement or two. Where two statements are presented, they will comprise an income statement, totalling to profit or loss, and a separate statement of comprehensive income starting with the profit or loss for the period and showing each component of other comprehensive income. The separate statement of comprehensive income must follow immediately after the income statement.

Alternatively, the entity may choose to present a single statement of comprehensive income including the components of profit or loss, ie what would go in an income statement if presented separately, followed by the components of other comprehensive income.

Other comprehensive income is essentially all items of income and expense other than those included in the profit or loss for the period. Examples include the revaluation of property, plant and equipment, fair value remeasurement of available-for-sale financial assets and exchange differences on retranslation of foreign operations. Other comprehensive income does not include, for example, dividends or new share capital as these are transactions with owners in their capacity as such rather than income or expenses.

2.2 Statement of changes in equity

The statement of changes in equity must always be presented as a primary statement, regardless of whether the one or two statement approach is taken for the statement of comprehensive income.

The statement of changes in equity should give a reconciliation between opening and closing balances for each component of equity, showing:

- total comprehensive income
- the effects of retrospective changes to accounting policies and retrospective restatements for errors
- transactions with owners in their capacity as owners.

2.3 New titles for primary statements

IAS 1 (Revised 2007) introduces new terms for the primary statements, such as 'statement of financial position' instead of 'balance sheet' and 'statement of cash flows' instead of 'cash flow statement.' However, the new titles are not mandatory and companies in some countries may decide to continue using the headings 'balance sheet' and 'cash flow statement'.

The heading 'statement of comprehensive income' should be used, as there are differences between this and the statement of recognised income and expense under the previous version of IAS 1.

2.4 Additional comparative statement of financial position

An additional comparative statement of financial position (balance sheet) as at the beginning of the earliest comparative period is required whenever an accounting policy is applied retrospectively or there is a retrospective restatement of items in the financial statements, or when items in the financial statements are reclassified.

The additional comparative statement of financial position will be needed whenever a new or amended Standard is adopted for the first time and is applied retrospectively.

Whenever the additional comparative statement of financial position is given, the related notes should also include the extra comparative figures.

2.5 What will the financial statements look like?

For an illustration of the presentation required by IAS 1 (Revised 2007) please ask for a copy of the Grant Thornton International *Example Consolidated Financial Statements 2009*.

3 Disclosure of key judgements and sources of estimation uncertainty

3.1 Judgements

Applying IFRS may involve significant judgements about the application of certain accounting policies. IAS 1 *Presentation of Financial Statements* requires the disclosure of the judgements that management has made in applying an entity's accounting policies that have the most significant effect on the amounts recognised in the financial statements. In effect, a significant judgement is a view that management has taken in applying an accounting policy (IAS 1.122).

The disclosures will vary significantly from company to company according to the nature and extent of the judgements that management has to make. Management needs to assess carefully those areas of judgement that may require disclosure in the financial statements. It needs to identify any specific judgements it has made due to the nature of the business activities that the company is involved in.

This disclosure has become more important for those companies operating in areas affected by the economic downturn as investors wish to know exactly what key judgements management has made in relation to the financial statements.

IAS 1.123 includes some examples of the types of judgements that may be required. For companies affected by depressed economic conditions, judgements that are likely to be relevant include the timing of revenue recognition and judgements associated with impairment reviews. It is, however, important to identify the judgements specific to the reporting entity in concern.

3.2 Sources of estimation uncertainty

In addition to disclosing significant judgements, management must disclose key assumptions concerning the future that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year (IAS 1.125).

These assumptions regarding the effects of uncertain future events are likely to be the most subjective and complex estimates that management makes. Careful consideration needs to be given to ensure that the reader of the financial statements understands clearly the uncertainties described as well as the range of possible outcomes that might result from these uncertain future events.

As for disclosure of judgements, the estimation uncertainties disclosed will be specific to each reporting entity. However, IAS 1.129 gives some examples of areas that may be relevant and the types of disclosures that can be made in order to help users to understand the uncertainty. These include:

- the nature of the assumption or other estimation uncertainty
- the sensitivity of carrying amounts to the methods, assumptions and calculation, including explanations of the sensitivities
- the expected resolution of any uncertainty and the range of possible outcomes within the next financial year
- an explanation of changes made to past assumptions concerning those assets and liabilities, if the uncertainty remains unresolved.

3.3 Continuing regulatory concerns

Regulators continue to challenge companies whose disclosures relating to judgements and uncertainties appear unclear or incomplete.

Many regulators have expressed concern that disclosures are often still boiler-plate and limited, thus providing little insight into the impact of reasonably possible alternative assumptions on the company's financial position. Regulators in some areas have also expressed disappointment that there has been no discernable increase in the number of companies making disclosure of the sensitivity of key sources of estimation uncertainty. This is despite continuing difficulties in financial markets in many areas of the world. More generally companies are encouraged to be more candid about the sources of the uncertainties they face and to identify the specific consequences for their financial position.

4 Going concern issues

4.1 Going concern

For companies in areas of the world that continue to experience difficult economic conditions, the assumption that the business is a going concern may no longer be clear-cut in some cases. Management may need to make careful judgements relating to going concern.

Management needs to ensure that it is reasonable to conclude that it is appropriate to prepare the financial statements on a going concern basis. IAS 1.25 requires that, where management is aware in making its going concern assessment of material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to continue as a going concern, those uncertainties are disclosed in the financial statements.

4.2 Regulatory guidance

The UK's Financial Reporting Council (FRC) has recently released *Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009* (www.frc.org.uk). The guidance is intended to assist companies that have been adversely affected by economic conditions in making their financial announcements. Although it is written in a UK context, the guidance should be useful to the management of any company faced with uncertainties over the future of their company.

Three core principles can be drawn from the guidance:

- management should make and document a rigorous assessment of whether the company is a going concern when preparing annual and interim financial statements. The process carried out by management should be proportionate in nature and depth depending upon the size, level of financial risk and complexity of the company and its operations
- management should consider all available information about the future when concluding whether the company is a going concern. Its review should cover a period of at least twelve months from the end of the reporting period.
- management should make balanced, proportionate and clear disclosures about going concern for the financial statements to give a fair presentation.

4.3 Disclosures

When making financial announcements, management is required to publish statements about the assumptions it has made and in particular those which are specific to its circumstances.

Management should address these reporting challenges at an early stage in preparing the annual report and accounts as this will help to avoid any last-minute problems which could cause adverse investor reaction.

For financial reporting purposes, the assessment of going concern takes into account all available information about the future, which is at least, but is not limited to, twelve months from the end of the reporting period. Management has three potential conclusions:

- there are no material uncertainties and therefore no significant doubt regarding the entity's ability to continue as a going concern. Disclosures sufficient to give a fair presentation are still required, meaning that management needs to explain why it considers it appropriate to adopt the going concern basis, identify key risks and say how these have been addressed
- there are material uncertainties and therefore there is significant doubt over the entity's ability to continue as a going concern, thus giving rise to the need for additional disclosures under IAS 1.25
- the use of the going concern basis is not appropriate. In this case, additional disclosures are required to explain the basis of accounting adopted.

Depending on which conclusion is reached, the disclosures can be complex and difficult to compose and, if going concern might be an issue for the company, management should build in extra time to consider this.

5 Financial instruments - classification and measurement changes

5.1 Introduction of IFRS 9

On 12 November 2009, the IASB published IFRS 9 *Financial Instruments* (IFRS 9). IFRS 9 addresses the classification and measurement of financial assets and is part of the IASB's response to the financial crisis. The publication of the Standard represents the first part of the IASB's overall plan to replace IAS 39.

5.2 The main requirements of IFRS 9

Classification

IFRS 9 requires an entity to classify financial assets at either amortised cost or fair value on the basis of:

a) the entity's business model for managing the financial assets; and
b) the contractual cash flow characteristics of the financial asset.

Amortised cost measurement is required where the objective of the entity's business model is to hold the financial assets to collect the contractual cash flows; and the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

If a financial asset does not meet the criteria for amortised cost classification, it is measured at fair value. In addition, an entity can opt to designate a financial asset at fair value through profit or loss in some circumstances. At initial recognition, an entity may designate a financial asset that would otherwise be subsequently measured at amortised cost as measured at fair value through profit or loss. Such a designation can only be made, however, if it eliminates or significantly reduces an 'accounting mismatch' that would otherwise arise.

Treatment of gains and losses on assets at fair value

The default requirement under IFRS 9 is that a gain or a loss on a financial asset that is measured at fair value and is not part of a hedging relationship, is presented in profit or loss. At initial recognition, however, an entity may make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not held for trading. Amounts recognised in other comprehensive income are not subsequently transferred to profit or loss. The cumulative gain or loss may, however, be transferred within equity. Where this election is made, dividends are still recognised in profit or loss unless they clearly represent a recovery of part of the cost of the investment.

Impairment

The reduction in the number of financial asset categories from four to two means that only one impairment method is necessary.

Impairment requirements are therefore only applied to financial assets measured at amortised cost. This contrasts with IAS 39, under which the greater number of measurement categories meant that differing impairment requirements were necessary.

5.3 Effective date and transition

Effective date

IFRS 9 is effective for annual periods beginning on or after 1 January 2013, with earlier application being permitted subject to the requirements of local law.

Transition

IFRS 9's transition rules are complex. In summary, the main requirements are as follows:

- IFRS 9 is required to be applied retrospectively subject to certain transitional provisions. For the purpose of applying these transitional provisions, it is necessary to determine the date of initial application (which is the date when an entity first applies the requirements of IFRS 9).
- under the transitional rules, application of IFRS 9's classification requirements (determining whether financial assets are classified at fair value or amortised cost) is based on the facts and circumstances at the date of initial application. The resulting classification is applied retrospectively.
- the transitional rules also state that if an entity adopts IFRS 9 for reporting periods beginning before 1 January 2012, it need not restate prior periods. If this is the case, the entity adjusts the opening retained earnings of the reporting period of initial application.

5.4 Advantages and disadvantages of early adoption

Companies are faced with the decision over whether to adopt IFRS 9 early or to stay with IAS 39's existing requirements for the time being (subject of course to IFRS 9 being adopted by the applicable jurisdictional authority - which has not yet happened in Europe). In making this decision, it is worth bearing in mind the following advantages and disadvantages:

Advantages

- reduced complexity in accounting for financial assets as a result of having only two measurement categories
- improved ability to align accounting with the company's business model for managing financial assets
- gives a (one-off) opportunity to reclassify financial assets on initial adoption (assuming all the criteria are met)
- only one set of impairment rules needs to be considered, with no separate impairment assessment (or losses) for investment in equity instruments.

Disadvantages

- need to re-evaluate the classification of all instruments within the scope of IAS 39, with limited time for entities to complete the assessment and implement system changes
- restricted ability to reclassify financial instruments on an ongoing basis
- inability to assess the overall impact of the IASB's overhaul of IAS 39 until the remaining phases are complete (it is possible IFRS 9 may change as a result of decisions made in later phases or as a result of convergence with US GAAP)
- the possibility of accounting mismatches where IFRS 9's requirements are incompatible with existing hedge accounting designations.

6 Accounting for acquisitions

6.1 Changes to IFRS 3

A revised version of IFRS 3 *Business Combinations* was issued in 2008 and is effective for business combinations occurring in annual periods beginning on or after 1 July 2009. The amended IAS 27 *Consolidated and Separate Financial Statements* applies at the same time. The regulatory study discussed below was based on accounts prepared applying IFRS 3 *Business Combinations* as issued in 2004, which is the Standard that is relevant for 31 December 2009 year ends, assuming no early adoption of the revised Standard. The remainder of this section discusses issues under IFRS 3 (2004). Key changes in the revised Standard are highlighted in Section 19.1.

6.2 Regulatory study on accounting for acquisitions

In late 2009, the UK Financial Reporting Council undertook a review entitled *Accounting for Acquisitions*. This review looked at 20 acquisitions which had taken place during 2008 and which were accounted for under IFRS 3, all of which were material to the acquirer. Although the review focused on UK companies, its findings are of wider general relevance.

The results were published in January 2010. The aim was to help companies identify areas for improvement in their accounting for acquisitions. The review found that in some cases it was difficult to identify the required disclosures in the accounts, and in other cases there was inconsistency between the information provided in the notes to the financial statements and that provided in accompanying management commentary.

6.3 Disclosures relating to goodwill

IFRS 3 requires disclosure of the factors that contribute to goodwill, including a description of each intangible asset that is not recorded separately. This information should be given for each material acquisition.

The results of the review highlighted this disclosure requirement as an area where significant improvements are needed. Of the 20 companies surveyed, six failed to give the disclosure at all. Where the disclosure was given, the review found that the information provided was not informative in any of the financial statements reviewed. Where disclosures were given, they tended to be generic and did not provide information specific to the business acquired.

In order for this information to be meaningful, acquirers should ensure that it is specific and provides sufficient detail so that readers of the accounts can understand the factors giving rise to goodwill. This could include, for example, reference to a workforce with specific skills, or to customer relationships which are neither contractual nor separable and therefore do not qualify for separate recognition as intangible assets.

6.4 Disclosures relating to intangible assets

IFRS 3 requires companies to disclose the amounts recognised for each class of assets acquired in each acquisition. This will include disclosing each class of intangible asset separately.

The review found that all but two of the companies in its sample had identified at least one class of intangible asset acquired in business combinations. However, some of the companies surveyed had aggregated intangible assets arising from a number of acquisitions in the period, even where individual acquisitions were material. This does not comply with the disclosure requirement, as the information should be given separately for each material business combination.

A further area for improvement identified by the UK regulator is in the identification of meaningful classes of intangible assets acquired. In particular, customer-related intangible assets appear to cause problems. Whilst customer-related intangible assets were identified by 15 out of the 20 companies in the review, only one company differentiated between customer contracts and non-contractual customer relationships.

6.5 Other disclosures relating to acquisitions

IFRS 3 requires companies to make several other disclosures relating to the effects of acquisitions. These include disclosure of:

- the amount of the acquiree's profit or loss since the acquisition date included in the acquirer's profit or loss for the period
- the revenue of the combined entity for the period as though the acquisition date for all business combinations effected during the period had been the beginning of that period
- the profit or loss of the combined entity for the period as though the acquisition date for all business combinations effected during the period had been the beginning of the period.

IFRS 3's disclosure requirements need careful attention in meeting the overall challenges of acquisition accounting.

7 Revenue

7.1 Introduction

Companies should consider their accounting policy for revenue recognition and whether it states that revenue "is recognised when risk and rewards are transferred" or "by reference to the stage of completion" without giving the reader an understanding of when that might be.

If the answer is yes to either of those quotes then the company may wish to reconsider its revenue recognition accounting policy. The wording above is generic and, in the words of regulators, "boilerplate" unless it is accompanied by detailed and specific explanations of how each revenue stream is recognised.

7.2 What do the regulators think?

The reporting of revenue continues to require significant attention. This area continues to be monitored closely by both regulators and investors. Management needs to ensure that the financial statements contain robust and detailed disclosures relating to the entity's revenue recognition policies and any critical judgements that management has made in relation to the recognition of revenue.

Regulators continue to focus questions on the adequacy of the stated revenue recognition policies. Companies may be asked to provide additional explanation where their disclosure does not appear to cover all apparent significant sources of revenue. Further questions may be raised in relation to companies that derive significant revenue from the provision of services but have not adequately explained how management establishes the stage of completion according to which revenue is measured.

7.3 Timing of revenue recognition

Continuing changes and uncertainties in many markets around the world may affect a company's ability to measure revenue reliably. Changes to the timing of revenue recognition and any other changes to revenue policies should be considered carefully by management.

Generally, revenue recognition does not follow milestone payments set out in contracts. Such progress payments and advances received from customers often do not reflect the extent to which services have been performed.

If a company is in the early stages of a contract for services, the outcome of the transaction might not be capable of reliable estimation. In such cases, revenue should be recognised only to the extent of the costs recognised that are recoverable.

7.4 Construction contracts

Where the outcome of a construction contract can be estimated reliably, revenue associated with that contract should be recognised by reference to the stage of completion as at the reporting date.

If the outcome cannot be estimated reliably, revenue should only be recognised to the extent that contract costs incurred are probable to be recovered. Any contract costs should be recognised as an expense in the period in which they are incurred.

7.5 Property construction

IFRIC 15 *Agreements for the Construction of Real Estate* was issued to standardise the accounting treatment of agreements to sell real estate before construction is complete. These arrangements include 'off plan' sales by real estate developers of apartments or houses. As issued by the IASB, IFRIC 15 is effective for accounting periods commencing on or after 1 January 2009.

IFRIC 15 was introduced because there were two different views as to the applicable revenue recognition practice. Some entities considered off-plan sales to be construction contracts and accounted for them under IAS 11 *Construction Contracts*, whereas others have treated them as a sale of goods under IAS 18 *Revenue*.

IFRIC 15 addresses two issues concerning treatment of agreements for construction of real estate before construction is complete:

- is the agreement within the scope of IAS 11 or IAS 18?
- when should revenue from the construction of real estate be recognised?

The consensus reached was that the answers to these questions depend on the terms of the agreements and the surrounding facts and circumstances and require the exercise of judgement. So what is the actual impact of IFRIC 15?

If, for example, someone buys a property 'off plan' and has no control over the physical design of the building, but can influence the furnishings, this would be an agreement for the sale of goods under IFRIC 15 and therefore within the scope of IAS 18. By contrast, where the buyer is able to specify major structural elements of the design of the property before construction begins or specify major changes once the construction is in progress, then IFRIC 15 clarifies that this is a construction contract within the scope of IAS 11.

This means that for some entities the accounting previously followed may no longer be in line with the requirements of IFRIC 15 and retrospective restatement may be necessary.

7.6 Measurement of revenue

Deferred payment terms

If a company makes a sale on deferred payment terms, it is important to consider the impact of discounting on revenue recognition. If the effect of discounting to the present value is material, the revenue should be measured at its present value.

Bad debt risk

Revenue should be measured at the fair value of the consideration receivable. Therefore, if there is a risk of default that is known at the time of the sale, the fair value should take into account that risk of default.

8 Segmental disclosures

8.1 Introduction of IFRS 8

IFRS 8 *Operating Segments* replaced IAS 14 *Segment Reporting* with effect for annual periods commencing on or after 1 January 2009. Restatement of comparative information is required when IFRS 8 is adopted, unless the necessary information is not available and the cost to develop it would be excessive (which will not be the case in most situations).

The objective of IFRS 8 is set out in a core principle. This principle requires an entity to disclose information to enable users of its financial statements to evaluate the nature and financial effects of the business activities in which it engages and the economic environments in which it operates.

IFRS 8 requires entities to adopt a management approach to reporting on their operating segments. Therefore, the information reported in the annual financial statements will be the same as that used by management internally for evaluating segment performance and deciding how to allocate resources to operating segments. Thus, the management information disclosed may be prepared using non-IFRS measurement methods. IFRS 8 provides no exemptions on the grounds that disclosure would be commercially prejudicial.

8.2 Main changes compared to IAS 14

IAS 14 required the identification of segments based on industry types and geographical areas expected to have differing risks and returns. IFRS 8 requires the identification of operating segments on the basis of internal reports that are regularly reviewed by the chief operating decision maker (CODM). This term identifies a function, not necessarily a manager with a specific title. The function of the CODM is to allocate the group's resources and to assess the performance of the operating segments of the group.

The definition of an operating segment in IFRS 8 includes a component of an entity that sells primarily or exclusively to other components of the entity, if the entity is managed in that way. This is different from IAS 14, where an entity looked at external sales to define segments, and internal sales were disclosed only if material to the segment.

8.3 IFRS 8 disclosure requirements

The management approach to segment information in IFRS 8 has the effect that reportable segments and segment information will vary according to the information used by the CODM. As a result, disclosures will not be consistent between entities, even those operating in similar industries. It is therefore important that users are provided with an explanation of how management have identified the entity's operating segments and how the information reported to the CODM reconciles to the primary financial statements and therefore to normal IFRS principles. The disclosures required include both narrative and quantitative information.

It is unlikely that the segmental information will be IFRS-based. However, IFRS 8 requires reconciliations for totals for all reportable segments to the entity's reported IFRS figures.

8.4 Entity-wide disclosures

IFRS 8 requires entities (including those with only one reportable segment) to make certain product and service and geographical disclosures for the entity as a whole rather than by reportable segment. These are referred to as entity-wide disclosures and are particularly useful to a user of the financial statements when the segment disclosures do not otherwise include total revenues by product, service or revenue stream. These entity-wide disclosures are based on amounts incorporated in the IFRS financial statements rather than on a management basis.

Entity-wide disclosures include the extent of reliance on major customers (IFRS 8.34). If revenues from transactions with a single external customer amount to 10% or more of an entity's revenues, this fact needs to be disclosed, along with the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer.

8.5 Regulatory concerns

Some regulators have expressed concerns regarding compliance with IFRS 8. In the United Kingdom for example, the Financial Reporting Review Panel has highlighted a number of areas where companies are likely to be challenged. We believe these concerns are equally relevant to companies transitioning to IFRS 8 in other jurisdictions. The areas highlighted are listed below:

- only one operating segment is reported, but the group appears to be diverse with different businesses or with significant operations in different countries
- the operating analysis set out in the narrative report differs from the operating segments in the financial statements
- the titles and responsibilities of the management or executive management team imply an organisational structure which is not reflected in the operating segments
- the commentary in the narrative report focuses on non-IFRS measures whereas the segmental disclosures are based on IFRS amounts.

The UK regulator suggests that entities should test their initial conclusions about their segmental reporting by considering the following questions:

- what are the key operating decisions made in running the business?
- who makes these key operating decisions?
- who are the segment managers (as defined in IFRS 8) and who do they report to?
- how are the group's activities reported in the information used by management to review performance and make resource allocation decisions between segments?
- is any proposed aggregation of operating segments into one reportable segment supported by the aggregation criteria in the Standard, including consistency with the core principle?
- is the information about reportable segments based on IFRS measures or on an alternative basis?
- have the reported segment amounts been reconciled to the IFRS aggregate amounts?
- do the accounts describe the factors used to identify the reportable segments including the basis on which the company is organised?

As a final question, it is suggested that management should ask themselves whether the reported segments appear consistent with their internal reporting and, if not, why not?

9 Impairment testing and disclosure

9.1 Impairment testing of cash-generating units

As difficult trading conditions continue for many businesses, impairment testing will also continue to be a significant issue. In addition to the requirement in IAS 36 *Impairment of Assets* for annual impairment tests of goodwill, many businesses will have indicators of impairment requiring them to perform impairment tests on other assets.

IAS 36 requires impairment testing to be carried out at cash-generating unit (CGU) level. Goodwill and other assets need to be allocated to CGUs. If a business has more than one segment, it is critically important that goodwill is allocated to CGUs at least to the level of operating segments, as defined in IFRS 8 *Operating Segments*, and that impairment tests are performed at the appropriate level. Where there are CGUs smaller than operating segments to which goodwill is not allocated, those smaller CGUs must also be tested for impairment when an indicator exists.

Where the test shows that there is an impairment, the assets of the CGU must be written down. It is not permissible to cross-subsidise by offsetting a surplus of recoverable amount over carrying value from one CGU against a shortfall in another.

9.2 Assumptions in impairment tests

The assumptions underpinning impairment tests must be specific to the CGU. These include, for example, growth rates and discount rates. It is important to remember that the discount rates must reflect current market assessments of the time value of money and the risks specific to the asset for which future cash flow estimates have not been adjusted. In some areas of the world, the cost of finance for companies has increased even though headline interest rates are low (for example because companies are having to pay a higher risk premium on debt and because equity finance is difficult to attract). Such adverse market conditions will have an impact on the discount rate. The higher the discount rate, the more likely it will be that an impairment will arise.

Under IAS 36, projected cash flows must be based on reasonable and supportable assumptions and on the most recent budgets or forecasts approved by management. Any projections based on budgets and forecasts are normally limited to five years, with projections beyond this point extrapolated at a steady or declining growth rate. This growth rate is limited to the relevant average for the product, industry, country, etc unless a higher rate can be justified. The current economic conditions mean that assumptions, budgets, forecasts and projected growth rates are likely to be lower than in the past. Companies may find it difficult to prepare supportable forecasts even for as long as the five years permitted by IAS 36.

9.3 Disclosures

Disclosures about impairment testing continue to come under scrutiny, both from users of the financial statements such as investors, and by regulators. It is vital that disclosure given is specific to the reporting entity and to each individual CGU.

For entities with goodwill requiring an annual impairment test, extensive disclosures are required even where the test results in no impairment being recognised. Disclosures include the following:

- narrative disclosures about the way in which key assumptions are identified and quantified need to be detailed and specific; the disclosures should explain management's approach to determining estimates
- companies should be disclosing information by CGU, especially where there are significant amounts of goodwill allocated to more than one CGU
- companies should state the extent to which assumptions are consistent with external sources of information; this will be of particular importance in the current economic climate
- the effect of key assumptions made should be discussed and differences between CGUs disclosed
- if a reasonably possible change in a key assumption could give rise to an impairment, IAS 36 requires sensitivity disclosures.

The sensitivity analysis will be particularly relevant given the continuing uncertain economic climate, as impairment tests are likely to have less headroom than previously, making it more likely that a reasonably possible change would result in an impairment. Also, judgements about what is considered to be a reasonably possible change in a key assumption will be impacted by the significant market fluctuations that have been experienced in many countries recently.

10 Financial instruments disclosure changes

10.1 The IFRS 7 amendment

Important changes to IFRS 7 *Financial Instruments: Disclosures* are effective for annual periods beginning on or after 1 January 2009. The aim of the IFRS 7 changes is to ensure that entities explain more clearly how they determine the fair value of financial instruments and to improve the disclosure of liquidity risk. The amendments were part of the IASB's response to the credit crisis. In the first year of application an entity need not provide comparative information in respect of the new requirements.

10.2 Fair value measurement disclosures

The three-level fair value hierarchy

To improve the disclosure of how entities measure the fair value of their financial instruments, the amendments introduce a fair value hierarchy for disclosures.

The fair value hierarchy consists of the following three levels:

- Level 1 – quoted prices (unadjusted) in active markets for identical assets or liabilities
- Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices)
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs).

Determination of hierarchy level

Determining the level in the fair value hierarchy under which a financial asset or liability is categorised is based on the lowest level input that is significant to the fair value measurement of the instrument.

Assessing whether a particular input to the fair value measurement is significant may require judgement. The amendment makes it clear that when the fair value of an instrument is measured using observable inputs that require significant adjustment based on unobservable inputs, that fair value measurement should be categorised in Level 3 of the hierarchy.

The disclosures required

For financial instruments within the scope of IFRS 7 that are measured at fair value in the statement of financial position, the Standard requires entities to disclose the following for each class of financial instrument:

- the level in the fair value hierarchy into which the fair value measurements are categorised in their entirety
- any significant transfers between Level 1 and Level 2 of the fair value hierarchy and the reasons for those transfers
- for fair value measurements in Level 3 of the hierarchy, a reconciliation from the opening balances to the closing balances. As well as highlighting purchases, sales, and gains and losses, this reconciliation will identify transfers into or out of Level 3 and the reasons for those transfers.

In addition, for any fair value movements in Level 3, where changing one or more inputs to reasonably possible alternative assumptions would change fair value significantly, entities are required to disclose that fact and the effect of those changes.

10.3 Liquidity risk disclosures

The second part of the amendment improves the liquidity risk disclosures required by IFRS 7.39.

In accordance with the amendment, an entity discloses:

a) a maturity analysis for non-derivative financial liabilities that shows the remaining contractual maturities
b) a maturity analysis for derivative financial liabilities. The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows
c) a description of how it manages the liquidity risk inherent in (a) and (b).

Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

The most important change compared to the previous IFRS 7 liquidity risk disclosures relates to derivative financial liabilities. Under the previous version of IFRS 7, entities were required to disclose a quantitative maturity analysis for all derivative financial liabilities according to their contractual maturities. The change is a response to comments that the requirement to provide disclosures based on remaining contractual maturities was difficult to apply for some derivative financial liabilities and did not always result in information that reflects how many entities manage liquidity risk for such instruments. As a result, the amendments to IFRS 7 retain the requirements to disclose the remaining contractual maturities of derivative financial liabilities only where the information is essential for an understanding of the timing of the cash flows.

10.4 What needs to be done?

Entities will need to gather the additional information to enable them to meet the new disclosure requirements. The detailed quantitative and qualitative disclosures will require entities to retain details of purchases and sales of financial instruments and transfers between levels.

Furthermore management will need to assess the significance of inputs to its fair value measurement models, considering factors specific to each asset or liability. The term ‘significant’ is not defined and therefore this assessment will require judgement which may need to be disclosed as part of the IAS 1.122 significant judgements disclosure.

For further guidance, please ask for the Grant Thornton International publication *Financial Instruments on Display - Illustrative Disclosures and Guidance on IFRS 7*, which was updated in 2009 for the recent IFRS 7 changes.

11 Foreign currency

11.1 Currency volatility

In the current economic climate, there continues to be significant volatility in many exchange rates. This means that entities with overseas subsidiaries or significant foreign trade could find that exchange differences that may have been insignificant in the past now have a material impact on the financial statements.

The significance of exchange differences to the financial statements has highlighted a number of issues, which are discussed below.

11.2 Consolidated financial statements

There are several key issues to keep in mind in relation to consolidated financial statements and foreign currency:

- exchange differences on intra-group balances do not cancel out on consolidation. Although the actual intra-group balances cancel out in the statement of financial position, the exchange differences reported in a parent or subsidiary company's individual income statement continue to be recognised in consolidated profit or loss. Furthermore, these exchange differences affect the currency exposure and sensitivity disclosures under IFRS 7 *Financial Instruments: Disclosure*
- an exception to the above treatment of intra-group balances exists if the exchange differences arise on an intra-group loan where that loan is in substance part of the reporting entity's net investment in the foreign operation. In such a case, instead of being reflected in consolidated profit or loss, the exchange differences are recognised initially in a separate component of equity and then recycled to profit or loss on disposal of the net investment
- the assets, liabilities and results of individual entities are translated into the parent's presentational currency. Whilst assets and liabilities are translated at the closing rate, IAS 21 *The Effects of Changes in Foreign Exchange Rates* requires the actual rate to be used for results, though the average rate may be used if it is a reasonable approximation (see Section 11.3)
- goodwill and fair value adjustments arising on an acquisition of a foreign operation are retranslated at the reporting date closing rate.

11.3 Use of average exchange rates

The use of average exchange rates to translate foreign currency transactions over a period into the entity's functional currency is permitted if the average rate is a reasonable approximation of the actual rate on the transaction dates. The same applies to translating the results of foreign operations for consolidation.

In times of significant exchange rate fluctuation, it may not be appropriate to use average rates or, if average rates are used, the period over which the average is determined may need to be reduced. Similar considerations apply to translating the results of foreign operations for consolidation and translation into a presentation currency, where applicable. Given the continued fluctuations in the foreign currency markets, the use of average rates may be difficult to justify.

11.4 Inter-company balances

Recent volatility in foreign exchange rates has resulted in significant exchange gains and losses on many inter-company balances denominated in foreign currency (including loans and trading balances).

If the individual accounts of the parent or subsidiaries are prepared under IFRS, IAS 21 mandates that the respective companies retranslate inter-company balances at each reporting date and that exchange differences are reflected in profit or loss. IAS 21 requires this treatment even if the inter-company balance forms part of the 'net investment' in the consolidated accounts (see Section 11.2). This may have tax implications in some jurisdictions.

11.5 Functional versus presentation currency

A common mistake within group accounting policies is to refer to a group functional currency. IAS 21.8 defines functional currency as the currency of the primary economic environment in which the entity operates. Normally, this is the currency in which the entity primarily generates and expends cash. Functional currency is specific for each entity. A group is normally a collection of individual entities (a parent and subsidiaries). Therefore there is no such thing as a group functional currency.

There is no choice of functional currency. IAS 21 provides guidance in the form of primary and secondary indicators of economic factors and circumstances that should be considered in determining the functional currency. Applying this guidance to determine functional currency may require significant judgement, in which case disclosure may be required by IAS 1 *Presentation of Financial Statements*.

The presentation currency is the currency in which the financial statements are presented. This is a matter of choice. Where the presentation currency is different from the functional currency IAS 21.53 requires the entity to state this fact and disclose the reasons for the choice of a different presentation currency. The ability to choose a presentation currency does not however negate the importance of the functional currency determination.

The functional currency determination will directly affect the amount of exchange differences reported in profit or loss. The results and balances must always be converted initially into the functional currency and this process derives those exchange differences that are reflected in profit or loss. If the presentation currency is different to the reporting entity's functional currency, this creates an additional stage to the conversion process, and in this latter process the additional exchange differences arising are brought to equity.

12 Raising finance and related issues

12.1 Raising finance: debt for equity swaps

In recent times many companies around the world have sought to restructure their finances by issuing shares to lenders in settlement of debt such as bank loans (often called a 'debt-for-equity swap'). Due to the significant diversity in practice in accounting for debt-for-equity swaps, IFRIC 19 *Extinguishing Financial Liabilities with Equity Instruments* was published in November 2009. IFRIC 19 addresses the accounting by an entity when the terms of a financial liability are renegotiated and result in the entity issuing equity. Note that IFRIC 19 only addresses the accounting by the borrower.

Though IFRIC 19 is not mandatory until annual periods commencing on or after 1 July 2010, it nevertheless provides a strong indicator of best practice in determining an accounting policy for debt-for-equity swaps where a company has no such policy at present.

IFRIC 19 interprets paragraph 41 of IAS 39 *Financial Instruments: Recognition and Measurement*, which requires that the difference between the carrying amount of a financial liability (or part thereof) extinguished and the consideration paid (including non-cash assets transferred or liabilities assumed) is recognised in profit or loss.

IFRIC 19 requires that the issue of equity instruments is treated as consideration paid in accordance with IAS 39.41. The equity instruments issued to the creditor to extinguish a financial liability are measured initially at the fair value of the equity instruments issued, unless that fair value cannot be measured reliably. If the fair value of the equity instruments issued cannot be measured reliably, those equity instruments are measured to reflect the fair value of the financial liability extinguished. The difference between the carrying amount of the financial liability and the consideration paid is recognised in profit or loss.

12.2 Loan covenants

Under IAS 1 *Presentation of Financial Statements*, if an entity breaches an undertaking under a loan agreement on or before the reporting date, and that breach allows the bank to demand immediate repayment, the loan is classified as a current liability. This is because, at the reporting date, the entity does not have an unconditional right to defer settlement for at least twelve months after that date.

Waivers

A company may obtain a waiver or period of grace from its lender. The timing of such a concession is critical to the classification of the loan within the accounts. The loan will still need to be disclosed as current where a covenant breach has occurred at the reporting date even if the lender agreed, after the reporting date and before the financial statements were approved, not to demand payment as a consequence of the breach. This is because a waiver after the reporting date does not affect the conditions that existed at the reporting date.

However, the liability is classified as non-current if the lender agreed by the reporting date to provide a waiver or period of grace ending at least twelve months after the reporting date, within which time the company can rectify the breach and the lender cannot demand immediate repayment. Therefore, putting a waiver or period of grace in place prior to the reporting date is essential if it is to impact on the current/non-current classification of the loan.

Covenant tested at a later date

There are cases where, although a financial covenant is based on figures at the reporting date, the date of the covenant testing is subsequent to the reporting date.

Where a breach of covenant is reported to the lender after the reporting date but the assessment is based on the financial condition of the borrower at the reporting date, this will result in classification of the loan as current (assuming that the covenant breach results in the bank having the right to demand repayment). Accordingly, if a covenant test is breached based on year end figures then classification as a current liability will result. This applies regardless of whether the test is carried out after the reporting date (for example, such as where it is based on audited annual accounts which are not approved until after the reporting date).

12.3 Changing loan terms

Another way companies might seek to restructure their financing arrangements is to renegotiate the terms of existing loan agreements and other finance contracts. The accounting requirements (and the reflection of any gain or loss) will depend on the particular circumstances. The accounting treatment would typically depend on:

- the IAS 32 classification of the instruments affected (debt, equity or compound) prior to the modification
- the IAS 32 classifications of any newly-issued instruments
- whether any debt instruments are modified and, if so, whether those modifications are significant
- whether modification of instruments has altered the IAS 32 classification or has created embedded derivatives.

If the modifications are considered to be significant, IAS 39 requires the company to treat the original loan as extinguished and recognise the modified liability as a new loan (initially at fair value). Extinguishment of the original loan will give rise to a gain or loss recognised in profit or loss under IAS 39.41.

12.4 Fair value of derivatives

The economic downturn experienced in some areas of the world has led to significant volatility in the markets, which means that fair values are more volatile. Where management uses a bank to value derivatives, it may wish to check that the bank has explained properly the basis of its fair value calculations and the underlying assumptions used.

Market volatility can lead to changes in the fair value of derivatives, giving rise to additional issues. Companies will need to account for any fair value movements on derivatives held. These fair value movements will be accounted for through profit or loss, thus impacting on reported results, unless hedge accounting applies. (Hedge accounting is subject to significant constraints and can only be applied where formal designation has been made.)

Derivatives in a liability position require more disclosure. IFRS 7 requires a maturity analysis of financial liabilities, which a company may not have had to disclose hitherto (see Section 10 for more on financial instruments disclosure changes).

13 Discount rates

13.1 Introduction

Discounted cash flow techniques are used widely under IFRS as the basis of measurement of assets and liabilities. The precise discount rate used often depends on the Standard under which the item in question is measured.

Market conditions in many areas of the world have impacted on the cost of debt and the cost of equity, the result being that discount rates may have changed significantly and are likely to be subject to scrutiny. This section considers the requirements for discount rates in different Standards.

13.2 Employee benefits

When calculating the present value of a defined benefit obligation, IAS 19 *Employee Benefits* requires discount rates to be determined by reference to market yields at the reporting date on high quality corporate bonds.

As the discount rate can have a significant, often very material, impact on the valuation of the defined benefit obligation, management will need to assess the basis for choosing an appropriate index and consider whether any adjustments should be made to that discount rate. The questions management might need to consider include:

- what duration are the liabilities within the pension scheme? The term of the bonds in the index should be consistent with the estimated term of the defined benefit obligations
- what index has been used for the discount rate and what are the constituents of that index? Due to the liquidity problems experienced by some companies recently, their bonds may have been downgraded and yet still be included in a particular index
- what adjustments should be made to the index rate and why?

When deciding on an appropriate discount rate, management will need to consider these questions and document clearly its rationale for the choice of discount rate.

13.3 Impairment of assets

A pre-tax discount rate must be used to calculate the value in use of an asset or cash-generating unit (CGU) for the purposes of IAS 36 *Impairment of Assets*. This discount rate should reflect 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.

A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset or CGU.

The cost of debt and the cost of equity have increased for many companies in recent times, even in countries where headline interest rates have been reduced to stimulate economic recovery. The impact is that the discount rate to be used for the value-in-use calculation may have increased, which will reduce the present value of the cash flows and hence potentially reduce the recoverable amount of the asset or CGU.

IAS 36 requires a market rate to be used but notes that if such a rate is not available in the market it should be estimated. A possible starting point for a discount rate might be the company's weighted average cost of capital. However, this would need to be adjusted to reflect the way that the market would assess the specific risks associated with the asset's estimated cash flows and exclude risks that are not relevant to the asset's estimated cash flows.

In general increasing risk will result in a higher discount rate that will in turn result in a lower value in use and possibly a lower recoverable amount. The Standard lists risks that will need to be considered; these are:

- country risk
- currency risk
- price risk.

Where several different assets or CGUs are being tested for impairment, for example goodwill allocated to segments, the discount rate for each will need to reflect the risks specific to that asset or cash-generating unit.

Again, management will need to articulate clearly its justifications as to its estimation of discount rates.

13.4 Other areas that may require discount rates

Share-based payment – IFRS 2

In estimating the fair value of an option granted under a share-based payment, one of the inputs into the model will be the risk-free interest rate.

Provisions, contingent liabilities and contingent assets – IAS 37

A provision should be recognised at its present value using a pre-tax rate that reflects current market assessments of the time value of money and the risks specific to the liability.

Financial instruments: recognition and measurement – IAS 39

The fair value measurement of certain financial instruments and the measurement of impairment of financial instruments may require the use of discount rates.

For example, calculating the fair value of the debt component of a compound instrument requires the use of a market rate of interest that reflects the interest rate available on a similar debt instrument. 'Similar debt instrument' effectively means that the instrument will have a similar maturity, cash flow pattern, currency, credit risk, collateral and interest basis.

13.5 Conclusion

IFRS requires the use of discount rates in various areas, and the selection of these discount rates is always important. In addition, difficult market conditions in many areas of the world have resulted in significant fluctuations in the cost of debt and of equity, complicating the decision. Management will need to document and explain the reasons for any decisions it makes in selecting appropriate discount rates to ensure its choices of discount rates are in accordance with the relevant accounting Standards.

14 Taxation – key current issues

14.1 Recognition of deferred tax assets

Deferred tax assets can be recognised under IAS 12 *Income Taxes* only in certain restrictive circumstances. In general, deferred tax assets should be recognised only to the extent that it is probable that taxable profits will be available against which the deductible temporary difference can be utilised.

Subject to certain conditions, a deferred tax asset is recoverable, and hence is recognised, if:

- there are taxable temporary differences against which the deductible temporary difference can be utilised, or
- it is probable that there will be sufficient future taxable profits, or
- tax planning opportunities are available to create taxable profit.

The existence of unused tax losses is strong evidence that future taxable profits may not be available. Therefore, if a company has a history of recent losses, and in the absence of sufficient taxable temporary differences, a deferred tax asset should be recognised only if there is convincing evidence that sufficient taxable profits will arise to enable the deductible temporary difference to be utilised.

Given the difficult economic environment in some areas of the world, convincing evidence may be more difficult to identify for some companies. If this evidence is not available, a deferred tax asset cannot be recognised.

Management should be aware that additional disclosures are required by IAS 12 where there is a history of losses but a deferred tax asset is recognised.

14.2 Offsetting

IAS 12 allows offsetting of current tax assets against current tax liabilities and deferred tax assets against deferred tax liabilities. Current tax assets and liabilities may be offset only if the entity has a legally enforceable right to set off the recognised amounts and intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously. Deferred tax assets may be offset against deferred tax liabilities if, and only if, the entity has a legally enforceable right to set off current tax assets against current tax liabilities and the deferred tax assets and liabilities relate to income taxes levied by the same taxation authority on either:

- the same taxable entity, or
- different taxable entities which intend either to settle current tax liabilities on a net basis, or to realise the assets and settle the liabilities simultaneously, in each future period in which significant deferred tax is expected to reverse.

Care should be taken that the guidance in the Standard is correctly observed and that deferred tax balances are not inappropriately netted off.

15 Share-based payments

15.1 Introduction
Rewarding employees partly through share-based payments is becoming more commonplace. The amendment to IFRS 2 *Share-based Payment* dealing with vesting conditions and cancellations, which applies for periods beginning on or after 1 January 2009, affects the way in which share-based payments are accounted for. In addition, continuing economic uncertainty in some countries has impacted on share-based payments in several ways.

15.2 Non-vesting conditions
The amendment to IFRS 2 on vesting conditions and cancellations introduces the term 'non-vesting conditions'. These are conditions associated with a share-based payment award that do not affect whether or not the entity receives the services which entitle the employee to the award. An example is a scheme under which employees are required to save part of their salary for a set period and are entitled to a share award upon completion of the saving period (known as Save As You Earn schemes in some countries). An employee can stop saving in such a scheme, therefore losing their entitlement to the award, but continue working for the entity.

A non-vesting condition is taken into account in estimating the fair value of the award granted. If the ability to meet the non-vesting condition is within the control of one of the parties then failure to meet that condition is treated as a cancellation. However, if the non-vesting condition is not within the control of either party then the entity continues to record a charge in profit or loss ignoring the fact that the non-vesting condition has been failed.

15.3 Failure to meet performance conditions
In the difficult economic conditions being encountered in some countries, some share-based payment awards will fail to vest due to performance conditions not being met. The accounting effects of this depend on the reasons for the conditions not being met. If failure to vest relates to actual or expected failure to meet a non-market performance condition (eg earnings target) this results in a reversal of any previous share-based payment expense. By contrast, failing to vest due to failing a market condition (eg target share price) does not result in any reversal.

In the case of equity-settled share-based payments, the fair value of the award is determined at grant date and not remeasured subsequently. This means that the accounting is not impacted by the value of the award to the employee falling over the vesting period. Similarly, where awards are not exercised after vesting, for example because they are out of the money, this does not impact on the accounting and there is no reversal of the charge.

15.4 Modifications and cancellations
When the value of their shares falls, companies may consider modifying the terms of equity-settled share-based payments to ensure that they remain an effective incentive to the employees to whom they have been granted.

Any modifications that increase fair value, such as a reduction in the exercise price, will result in an additional share-based payment expense. The additional expense is based on the incremental fair value, being the difference between the fair value of the modified equity instrument and that of the original equity instrument, both measured at the date of modification. This is recognised over the remainder of the vesting period in addition to the share-based payment expense based on the grant-date fair value of the original award.

Furthermore, when an equity-settled share-based payment is cancelled, this usually results in an increased expense in the period of the cancellation, rather than a reduced expense. This is because cancellations are accounted for as an acceleration of vesting of the award.

16 Other employee benefits issues

16.1 Defined benefit pension schemes

Recent economic conditions have accelerated an existing trend of companies closing defined benefit pension plans to new entrants, and reviewing the benefits provided to existing members. This means that curtailments and settlements have become more common, and this is expected to continue. A curtailment occurs either when an employer is committed to make a significant reduction in the number of employees covered by the scheme or amends the terms of the scheme so that a material element of future services by current members will qualify for reduced, or no, benefits. A settlement results from an entity entering into a transaction that removes all further obligations for part or all of the benefits under a scheme.

Where there is a curtailment or settlement, IAS 19 *Employee Benefits* requires the defined benefit obligation to be remeasured using current actuarial assumptions before determining the effect of a curtailment or settlement. Where management are considering an action that would result in either a curtailment or settlement, the need to obtain actuarial advice at or around the date of the event should be considered. IAS 19 requires the effects of curtailments or settlements to be recognised in profit or loss.

16.2 Restructuring and redundancy costs

Ongoing economic difficulties in some areas of the world have meant that many businesses have had to restructure and reduce their workforce. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* contains specific guidance on providing for restructuring costs. IAS 19 *Employee Benefits* has similar (but not identical) guidance on termination benefits.

A provision for restructuring should be made only when there is a detailed formal plan and the entity has raised a valid expectation in those affected that it will carry out the restructuring, either by starting to implement the plan or by announcing the main features of it.

16.3 Key management personnel compensation

IAS 24 *Related Party Disclosures* requires entities to identify their key management personnel and disclose the compensation paid to them. Key management personnel are those people who have both the authority and responsibility for planning, directing and controlling the activities of the entity. The definition includes all directors, but may include other employees as well.

The disclosure is required to be split into short-term benefits, post-employment benefits, other long-term benefits, termination benefits and share-based payments. The IAS 24 disclosure may differ from the disclosure requirements of local law, and companies should be aware of this in making their disclosures.

17 Capital disclosures

17.1 Introduction

IAS 1 *Presentation of Financial Statements* was amended in 2007 to require companies to make additional disclosures to allow users of accounts to evaluate the company's objectives, policies and processes for managing capital. The required disclosures are set out in IAS 1.134-6. Regulators have noted that this disclosure is often overlooked and that companies do not define what is managed as capital, which means that disclosures given are not meaningful.

17.2 Capital

IFRS does not define capital and IAS 1 therefore requires a company to define what it manages as capital for the purpose of these disclosures. These disclosures include a description of how the company is meeting its objectives for managing capital, summary quantitative information and the degree of compliance with any externally imposed capital requirements to which the entity is subject. Boilerplate disclosures will not meet the requirements as disclosure should be based on management information, which will be specific to each entity.

Capital is much broader than nominal share capital. Regulators have noted that where companies do not first establish what they manage as capital, subsequent disclosures are not meaningful. The importance of this information in periods of economic downturn is much greater than during periods of growth. The disclosures will therefore be particularly significant to those parts of the world that are experiencing difficult economic conditions. Users need to understand how a company is managing its capital in periods of no or slow growth. Information about the dividend policy, for example, and share buy-back arrangements is particularly relevant to a user's assessment of stewardship and how prepared management is to face the challenges of a recession. Regulators have noted that poor disclosure in this area could obscure the extent of expected capital raising.

17.3 Expectation

It is expected that this area of reporting will improve as companies familiarise themselves with the IAS 1 disclosure requirements and give the correct weight to the significance of this information during periods of recession. The expectation is that companies will need to give more detailed disclosures in relation to capital during times of recession than in periods of economic growth.

18 Additional exemptions for first-time IFRS adopters

18.1 Introduction

In July 2009, the IASB published *Additional Exemptions for First-time Adopters (Amendments to IFRS 1).* The publication amends IFRS 1 to address potential impediments to adopting IFRS in certain jurisdictions, and aims to offer a pragmatic solution to them.

The additional exemptions relate to:

- the measurement of deemed cost for certain oil and gas assets
- the measurement of decommissioning liabilities included in the deemed cost of such oil and gas assets
- the timing of the determination of whether an arrangement contains a lease.

The Amendments to IFRS 1 offer relief from retrospective application of IFRSs in selected areas, to ensure that entities applying IFRSs will not face undue cost or effort in the transition period.

18.2 Summary of the main amendments

Measurement of deemed cost for certain oil and gas assets

A first-time adopter which has previously accounted for its exploration and development costs for oil and gas properties in cost centres that include all properties in a large geographical area, may elect to measure such assets on the date of transition on the following basis:

- exploration and evaluation assets at the amount determined under the entity's previous GAAP; and
- assets in the development or production phases at the amount determined for the cost centre under the entity's previous GAAP. The entity shall allocate this amount to the cost centre's underlying assets pro rata using reserve volumes or reserve values as of that date. If the entity uses this exemption, it discloses that fact and the basis on which carrying amounts determined under the previous GAAP were allocated.

At the date of transition, the entity tests exploration and evaluation assets in the development and production phases for impairment in accordance with IFRS 6 *Exploration for and Evaluation of Mineral Resources* or IAS 36 *Impairment of Assets* respectively and, if necessary, reduces the amount determined above.

Decommissioning Liabilities

An entity which uses the deemed cost exemption relating to oil and gas assets, as discussed above:

- measures decommissioning, restoration and similar liabilities as of the transition date in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*; and
- recognises directly in retained earnings any difference between the amount measured under IAS 37 and the carrying amount of those liabilities under the entity's previous GAAP.

Leases

If a first-time adopter made the same determination of whether an arrangement contained a lease in accordance with its previous GAAP as that required by IFRIC 4 *Determining whether an Arrangement contains a Lease*, but at a date other than that required by IFRIC 4, the entity need not reassess that determination on the date of transition to IFRS.

18.3 Effective date

Amendments to IFRS 1 should be applied for annual periods beginning on or after 1 January 2010. Earlier application is permitted. If an entity applies the amendments for an earlier period, it shall disclose that fact.

18.4 Conclusion

Many entities around the world will be adopting IFRS for the first time in the next couple of years. An understanding of all the exemptions available to them under IFRS 1 *First-time Adoption of International Financial Reporting Standards* is essential in order to ensure a smooth and cost-effective transition to IFRS.

19 Key changes for 2010 and beyond

19.1 IFRS 3 revised – business combinations

The revised IFRS 3 *Business Combinations* was issued in 2008 and is effective for business combinations occurring in annual periods beginning on or after 1 July 2009. The amended IAS 27 *Consolidated and Separate Financial Statements* applies at the same time. IFRS 3 (Revised 2008) introduced significant changes to business combinations accounting. Three key changes are highlighted below.

Transaction costs

One key change to IFRS 3 is that directly attributable transaction costs are required to be expensed as incurred in the consolidated accounts. Previously these were part of the cost of the business combination and therefore included in goodwill. Examples of such costs include legal and accountancy fees. Under IFRS 3 (Revised 2008), consideration transferred only includes amounts paid to the vendor to obtain control of the acquiree, and therefore excludes these costs.

Contingent consideration

Another significant change relates to the accounting for contingent consideration. Where there is contingent consideration for a business combination, under IFRS 3 (Revised 2008) this is included at fair value in the consideration transferred at the acquisition date. Where contingent consideration gives rise to a financial liability, subsequent changes to fair value will be recognised in profit or loss, potentially leading to income statement volatility. Where contingent consideration meets the definition of equity under IAS 32 *Financial Instruments: Presentation*, there is no subsequent remeasurement.

Intangible assets

A further difference is that IFRS 3 (Revised 2008) concludes that all intangible assets acquired as part of a business combination should be capable of reliable measurement. This is expected to lead to more intangible assets being recognised than under the previous version of IFRS 3, under which intangible assets were not recognised separately if their fair value could not be measured reliably.

19.2 Group cash-settled share-based payments

The IASB has issued an amendment to IFRS 2 *Share-based Payment* entitled *Group Cash-settled Share-based Payment Transactions*. The amendment applies for annual periods commencing on or after 1 January 2010.

This amendment clarifies the scope of IFRS 2 and the accounting for group cash-settled share-based payment transactions in the separate or individual financial statements of the entity receiving the goods or services when that entity has no obligation to settle the share-based payment transaction.

This will impact subsidiary companies whose employees receive a cash-settled share-based payment award based on the shares of the parent company. Such subsidiaries will be required to recognise a share-based payment expense in their individual profit or loss, even though they have no obligation to settle the award. As the entity receiving services has no obligation, they will account for the award as equity-settled.

The company with the obligation to settle the award, which will typically be the parent company, will measure their obligation in accordance with the requirements applicable to cash-settled share-based payments.

The amendment also brings in to the Standard the guidance previously in IFRIC 8 *Scope of IFRS 2*, and IFRIC 11 *Group and Treasury Share Transactions*.

19.3 Revision to IAS 24 – related parties

The IASB issued a revised version of IAS 24 *Related Party Disclosures* in November 2009. The main change compared to the previous version is the introduction of an exemption from IAS 24's disclosures for transactions with a) a government that has control, joint control or significant influence over the reporting entity and b) 'government-related entities' (entities controlled, jointly controlled or significantly influenced by that same government). The IASB has also amended the definition of a related party to clarify the intended meaning and remove some inconsistencies. The revised Standard applies for annual periods commencing on or after 1 January 2011.

19.4 IFRS 9 – financial instruments

As discussed in detail in section 5, the first component of IFRS 9 *Financial Instruments* was published on 12 November 2009. The mandatory effective date of IFRS 9 will be for annual periods commencing on or after 1 January 2013. Early adoption is possible subject to the requirements of local law.

IFRS 9 uses a single approach to determine whether a financial asset is measured at amortised cost or fair value, replacing the many different rules in IAS 39. The approach in IFRS 9 is based on how an entity manages its financial instruments (its business model) and the contractual cash flow characteristics of the financial assets. The new Standard also requires a single impairment method to be used rather than the multiple impairment methods in IAS 39.

19.5 Joint ventures

A revised Standard on accounting for joint arrangements is due to be issued by the IASB in the first quarter of 2010. This is expected to change the definition of joint arrangements, defining two types of joint arrangements, being joint ventures and joint operations.

The key change is expected to be the removal of the option for proportionate consolidation of joint ventures, which is permitted currently under IAS 31 *Interests in Joint Ventures*. Instead, equity accounting will be the only treatment allowed for this type of joint arrangement.

19.6 Consolidation

The IASB has an ongoing project to revise IAS 27 *Consolidated and Separate Financial Statements*. An exposure draft was issued in December 2008 and a Standard is expected during 2010.

The new Standard is intended to be a single Standard on consolidation replacing the existing IAS 27 and SIC 12, *Consolidation – Special Purpose Entities*. The proposals include a revised definition of control which can be applied to all entities, and additional disclosure requirements.

20 Detail counts

20.1 Introduction

Based on the experience of the member firms within Grant Thornton International, attention to detail is important when preparing financial statements. This section highlights a selection of detailed areas where there is evidence that many companies encounter difficulties in achieving IFRS compliance.

20.2 Inventory

IAS 2 *Inventories* sets out the accounting requirements for inventories, covering how cost and subsequent expensing are to be determined, including any write-down to net realisable value. Many companies fail to provide the disclosure in relation to the amount of inventory recognised as an expense in the period (IAS 2.36(d)) or the amount of any write-down to net realisable value or the reversal of such write-downs (IAS 2.36(e) and (f)).

In addition, reduced output volumes and activity levels may lead to increased inventory obsolescence and a need for write-downs under IAS 2 to ensure that inventories are not stated at more than net realisable value. Lower production levels may raise questions over the appropriate allocation rate of fixed production overheads based on the normal capacity of the production facilities.

20.3 Standards in issue not yet effective

IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* requires entities that have not applied a new Standard or Interpretation, which has been published but is not yet effective, to make certain disclosures. Disclosures required include the fact that the new Standard or Interpretation is in issue and has not been applied, and known or reasonably estimable information relevant to assessing its possible impact on the financial statements in the period of initial application (IAS 8.30).

Our current view is that the disclosures need cover only those Standards and Interpretations that are expected to have an impact by changing an accounting policy or significant disclosures. This would include revisions to existing Standards that are expected to have an impact, as well as new Standards. The change in accounting policy would usually affect recognition or measurement but would also extend to changes in presentation or significant disclosure changes. Where a major new Standard is issued (eg the new business combinations Standard) it would be helpful to mention this, even if it will have no current impact.

20.4 Deferred tax disclosures

IAS 12 *Income Taxes* requires a number of detailed disclosures in relation to both current and deferred tax. Some of these disclosures are commonly omitted. These include:

- the amount of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the statement of financial position (balance sheet) (IAS 12.81(e)). Note that the required disclosure is not the amount of deferred tax not recognised
- the aggregate amount of temporary differences associated with investments in subsidiaries, branches and associates and interests in joint ventures, for which deferred tax liabilities have not been recognised (IAS 12.81(f)). Note again that the

required disclosure is not the amount of deferred tax not recognised

- in respect of each type of temporary difference and in respect of each type of unused tax losses and unused tax credits, the amount of deferred tax assets and liabilities recognised in the statement of financial position should be presented, and the amount of deferred tax income or expense recognised in profit or loss, if it is not apparent from the changes in amounts recognised in the statement of financial position (IAS 12.81(g)).

20.5 Employee benefits

Companies with defined benefit pension schemes need to provide a narrative description of the basis used to determine the overall expected rate of return on plan assets, including the effect of the major categories of plan assets (IAS 19.120A(l)).

20.6 Borrowing costs

IAS 23 *Borrowing Costs* requires disclosure of the amount of borrowing costs capitalised during the period and the capitalisation rate used to determine the amount of borrowing costs eligible for capitalisation (IAS 23.26).

20.7 Provisions and contingent liabilities

Some executory contracts, such as property leases and long-term supply agreements, may become onerous as a result of the entity no longer expecting to utilise the goods or services that it is obligated to purchase. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* requires provision to be made for onerous contracts.

Furthermore, increased levels of claims and litigation might be experienced in the current environment, leading to questions over the recognition of provisions and disclosure of contingent liabilities.

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Registered number: 05523714
Registered office: Regent's Place (7th Floor), 338 Euston Road, London NW1 3BG, UK