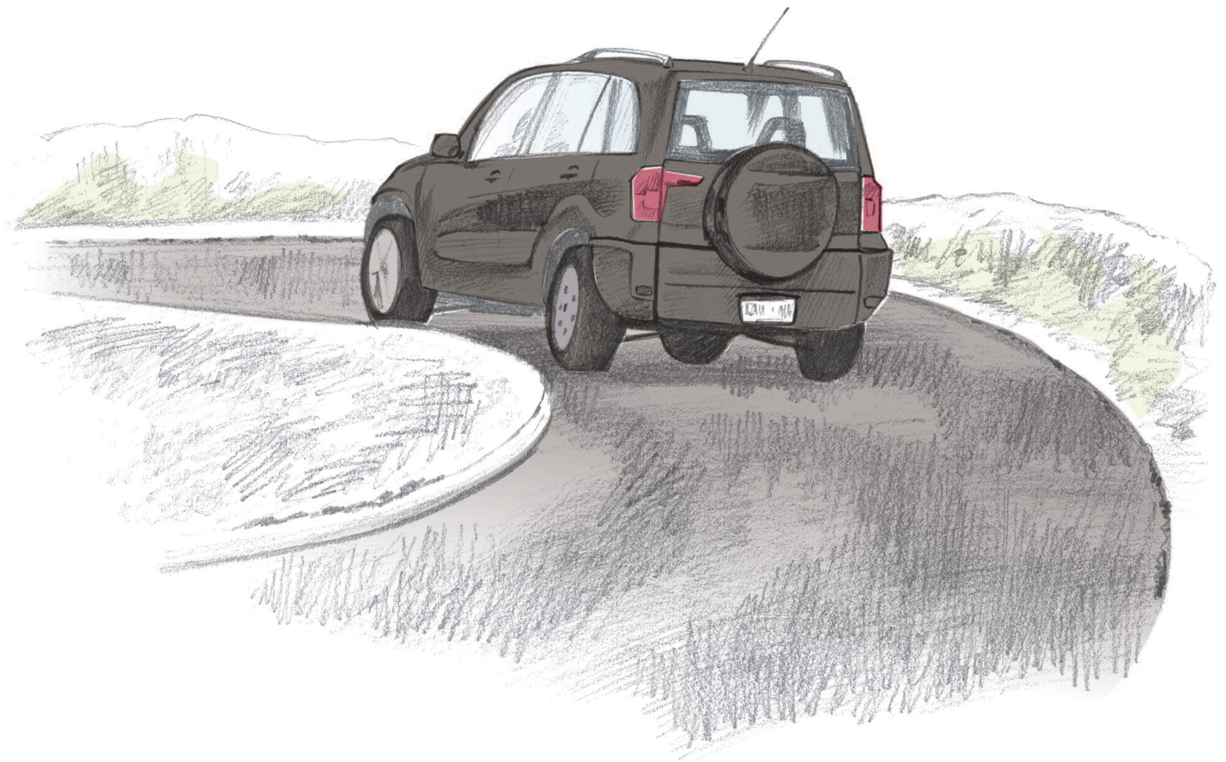
Grant Thornton

IFRS Top 20 Tracker

2011 edition



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Executive summary

Introduction

The 2011 edition of the IFRS Top 20 Tracker continues to take management through the top 20 disclosure and accounting issues identified by Grant Thornton International Ltd (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 2010.

Key themes driving selection of the issues in the 2011 edition are:

- key areas of interest for regulators
- issues related to the difficult adverse economic conditions that continue to affect many areas of the world
- challenging areas of accounting
- recent and forthcoming changes in financial reporting.

The IFRS Top 20 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 areas that we expect to be particularly significant for many Grant Thornton clients, and in turn to assist management in prioritisation and review.

Grant Thornton International Ltd
February 2011

1 Business combinations

IFRS 3 revised

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. IFRS 3 (Revised 2008) introduced significant changes to business combinations accounting, thereby creating potential pitfalls for the unwary. Some of these are highlighted below.

Transaction costs

One key change brought in by IFRS 3 (Revised 2008) is that directly attributable transaction costs are required to be expensed as incurred in the consolidated accounts. Previously these were capitalised as part of the cost of the business combination and were 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

It is common for acquisition arrangements to include an amount of consideration for which payment is contingent on the occurrence of a future event, or where the amount to be paid in the future varies dependent on, for example, the level of future profits of the acquiree. IFRS 3 (Revised 2008) has changed significantly the accounting for such contingent consideration.

Where there is contingent consideration in 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.

Acquisitions achieved in stages

IFRS 3 (Revised 2008) contains specific guidance on the accounting for a business combination where the acquirer previously had an equity interest in the acquiree, whether that equity interest was accounted for as an investment, an associate or a joint venture. Acquisition accounting is applied only at the date that control is obtained. This means, for example, that the purchase of a non-controlling interest in an existing subsidiary is not in the scope of IFRS 3 (Revised 2008); instead such transactions are accounted for under IAS 27 'Consolidated Financial Statements' (see Section 2).

At the date that control is achieved, any previously held equity interest in the acquiree is treated as if it were disposed of and reacquired at fair value. Any changes in value of the equity interest that were previously recognised in other comprehensive income are reclassified from equity to profit or loss, consistent with the treatment on a disposal. The fair value of the previously held equity interest is included in the calculation of goodwill, as the disposal of this at fair value is effectively treated as part of the consideration in the acquisition.

Intangible assets acquired

Recognition of intangible assets

A further difference is that in developing IFRS 3 (Revised 2008) the IASB concluded 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, where there was not the same presumption that intangible assets should be capable of reliable measurement.

Consistency with management commentary

Where a business combination is discussed by management in their narrative reporting, this may cover expected benefits of the acquisition such as the use of brand names or access to customer relationships. This should be consistent with the identification of intangible assets acquired in the notes to the financial statements. Regulators have advised management to consider carefully the consistency between the accounting for business combinations and their narrative reporting and public announcements.

Disclosure by class of assets

The disclosure requirements of IFRS 3 (Revised 2008) are extensive and include the amounts recognised at the acquisition date for each major class of assets acquired.

Regulators have challenged companies that have aggregated intangible assets into a single class when it has appeared from other information presented about an acquisition that there was in fact more than one class of intangible assets. Different classes of intangible assets might include, for example, brand names, customer contracts, patent rights and software.

Other changes

Indemnification assets

In an acquisition agreement, the seller may agree to indemnify the acquirer against a future uncertain liability, such as a warranty claim. IFRS 3 (Revised 2008) specifies that in this situation the acquirer recognises the liability, as it is an identifiable liability of the acquirer at the acquisition date, and also recognises an indemnification asset, which is measured on the same basis as the indemnified liability.

Settlement of pre-existing relationships

Where there is a pre-existing relationship between the acquirer and acquiree and this is settled as part of the business combination, IFRS 3 (Revised 2008) requires that any amount paid to settle the relationship is excluded from the consideration transferred. This amount is not considered to have been paid to gain control of the acquiree, and is therefore not part of the business combination.

Pre-existing relationships may be contractual, such as a licence agreement, or non-contractual, for example a lawsuit.

Re-acquired rights

The acquirer may have previously granted a right, for example, in a franchise agreement, to the acquiree. Where this is the case, IFRS 3 (Revised 2008) states that the re-acquired right is recognised as an intangible asset on acquisition, and is amortised over its remaining life.

2 Consolidated financial statements

Amended IAS 27

The amended IAS 27 'Consolidated and Separate Financial Statements' is effective for annual periods beginning on or after 1 July 2009. The revised IFRS 3 'Business Combinations' applies at the same time and changes brought in by that standard are discussed in Section 1.

Transactions with non-controlling interests

Non-controlling interests were known in the previous version of IAS 27 as minority interests. In the amended IAS 27, non-controlling interests are considered to be part of equity. The effect of this is that transactions between non-controlling interests and the parent which do not affect control are considered to be movements in equity. This means that:

- no profit or loss is recognised when the parent sells part of its equity interest but does not lose control
- there is no goodwill recognised on transactions where the parent purchases all or part of the non-controlling interest.

Disposal of a controlling interest

The disposal of a controlling interest in a subsidiary is accounted for under IAS 27. A parent might sell its interest in a subsidiary completely, or retain an equity interest giving significant influence or simply as an investment.

The amended IAS 27 requires that, when a parent loses control of a subsidiary, it derecognises the assets, liabilities and goodwill of the subsidiary, and any non-controlling interest on the date of disposal. Any amounts previously recognised in other comprehensive income in relation to the subsidiary will generally be reclassified to profit or loss.

Any retained equity interest in the former subsidiary is recognised at its fair value at the date of disposal.

Non-controlling interests in net liabilities

In a change to previous IFRS requirements, under the amended IAS 27, where losses attributable to the non-controlling interests exceed the non-controlling interest in the subsidiary's equity, the excess and any further losses continue to be attributed to the non-controlling interests. In such cases, non-controlling interests are shown as a debit balance within equity, separately from equity attributable to the parent shareholders.

The future of IAS 27

In 2009 the IASB issued an exposure draft of a proposed new standard on consolidation to replace IAS 27, and the standard is currently expected to be published in the first quarter of 2011.

The proposals in the exposure draft include a new, principle-based, definition of control of an entity that would apply to a wide range of situations and, in the IASB's view, would be more difficult to avoid by special structuring. The proposals also include enhanced disclosure requirements that would enable an investor to assess the extent to which a reporting entity has been involved in setting up special structures and the risks to which these special structures expose the entity.

3 Presentation of financial statements

Statement of comprehensive income

Under IAS 1 'Presentation of Financial Statements' the statement of comprehensive income may be presented either as a single statement or as two statements (ie an income statement and a statement of comprehensive income). In either case, the statement should contain only items that form part of comprehensive income. Whilst this is normally straightforward for components of profit or loss, identifying what is part of other comprehensive income continues to be a challenge for some companies.

Examples of other comprehensive income 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 payable or new share capital as these are transactions with owners in their capacity as such, rather than income or expenses. Hence, such items should not be shown in the statement of comprehensive income.

Statement of changes in equity

The statement of changes in equity must always be presented as a primary statement. The key elements of the statement are:

- total comprehensive income (split between parent and non-controlling interests)
- for each component of equity, the effects of retrospective application or retrospective restatements under IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'
- transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners
- a reconciliation between opening and closing balances for each component of equity.

When the revised IAS 1 was first issued, there was some confusion as to the level of detail relating to other comprehensive income required in the statement itself. The IASB has now addressed this by amending IAS 1 to clarify that the impact of individual items of other comprehensive income on each component of equity may be disclosed in a note to the financial statements. Though this amendment is not effective until periods commencing on or after 1 January 2011, it may be adopted early subject to the requirements of local legislation.

Additional comparative balance sheet

IAS 1 requires an additional comparative balance sheet (statement of financial position) to be presented as at the beginning of the earliest comparative period 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. This includes, for example, a voluntary change of accounting policy or presentation, as well as the retrospective application of a new or amended standard.

Disclosure of key judgements and estimates

IAS 1 requires disclosure of the judgements that management has made in applying an entity's accounting policies that have the most significant effect on the assets and liabilities 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). In addition to disclosing significant judgements, management are required to 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).

Regulators continue to pay close attention to disclosure of judgements and estimates. Evidence from regulators indicates that insufficient attention is being paid to providing appropriate disclosures to meet IAS 1's requirements. Omissions may become apparent from narrative reports accompanying the financial statements, which comment on matters that are not then highlighted as areas of significant judgement or estimation in the financial statements.

In disclosing key areas of estimation uncertainty, an important aspect of good quality disclosure is providing sensitivity analysis of carrying amounts to the methods, assumptions or estimates supporting their calculation.

So what is key?

When considering what judgements or estimates should be disclosed within the financial statements, management should consider what transactions or issues have led to significant discussions at board meetings. The more complex issues may highlight areas that require significant judgements impacting on the financial statements, for example should a subsidiary continue to be consolidated following a change in circumstances?

When challenged by regulators, some companies continue to assert that they have no significant judgements or estimates. However, the regulators believe that this is likely to be rare and they can be expected to probe such assertions.

Cash flow statement issues

Although IAS 1 addresses presentation of financial statements, the cash flow statement is governed by IAS 7 'Statement of Cash Flows'. Regulators have challenged companies regarding their cash flow statements. In some cases, these challenges resulted in companies being required to restate their cash flow statements. Treatment of foreign operations is addressed in Section 6. Other common issues are summarised below:

- IAS 7 requires all cash flows to be classified under one of three headings: operating, investing, financing. Thus, for example, acquisition of own shares is a financing cash flow not an operating one. Interest received is normally an operating or investing cash flow, not a financing one
- Only cash flows are presented in the cash flow statement. For example, the inception of a finance lease does not usually result in a cash flow and hence should not be presented in the cash flow statement
- IAS 7 defines cash equivalents as short-term, highly liquid investments that are readily convertible to known amounts of cash which are subject to an insignificant risk of change in value. These cash equivalents are therefore held to meet short-term cash requirements and do not normally include bank loans or longer-term deposits.

4 Revenue recognition

Revenue recognition policies

The revenue recognition policy is often the most important accounting policy in the financial statements. Revenue recognition continues to generate a significant number of questions from regulators. The key points remain that:

- the accounting policy is not set out in sufficient detail
- policies applied to the various revenue streams that companies have are not described
- areas of significant judgement are not explained.

None of these issues is new, yet it is evident that companies continue to fail to live up to regulators' and investors' expectations regarding disclosure of revenue recognition policies.

A number of companies have been asked for additional information to explain their accounting policies. They have also been questioned on whether the recognition criteria had been met to allow revenue to be recognised in certain circumstances.

Regulators are also challenging companies that include detailed accounting policies which relate to apparently immaterial revenue streams. Unnecessary clutter such as immaterial or irrelevant accounting policies should be eliminated from a good set of report and accounts.

Regulators can be expected to continue to look at revenue recognition and in the short term are likely to pay particular attention to those companies that appear to have aggressive accounting policies compared with their peer group.

Multiple-element arrangements

The aim of IAS 18 'Revenue' is to recognise revenue when, and to the extent that, goods have been delivered to a customer or services have been performed. However, a single transaction may contain a number of different elements. Take, for example, a contract which includes the sale of a computer, related training and on-going support. The recognition of revenue in this scenario may not be straightforward. IAS 18 requires a company to determine whether the contract should be accounted for as a single contract or whether it contains separately identifiable components that should be accounted for separately.

IAS 18 requires a company to apply its revenue recognition criteria to each separately identifiable component of a single transaction to reflect the transaction's substance. When identifying components of a contract, it is important to assess the contract from the perspective of the customer and not the seller. The key is to understand what the customer believes they are purchasing.

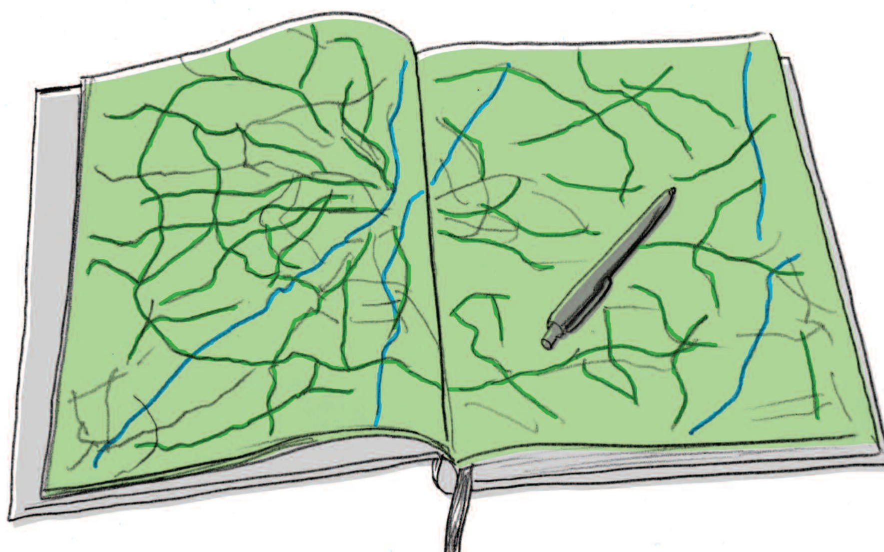
The accounting policy is part of a single story

Where management commentary (see section 15) is provided, it is important that it is consistent with the financial statements. For example where a company refers to several income streams in its narrative reporting or in segmental disclosures, it is important that the accounting policies set out for revenue address each of the income streams identified. If the policy does not, regulators may well ask for additional information to explain their revenue recognition.

When writing their accounting policies, directors should ask themselves "Does our stated policy fit with any management commentary about how the entity generates revenue?" If the answer is no, then the policy needs to be improved. The policy should reflect both the timing of the recognition and the measurement of revenue. Where companies have significant obligations in respect of customer returns, their accounting policies should address this issue.

Disclosures

In addition to requirements for the recognition and measurement of revenue, IAS 18 sets out specific disclosures that companies need to give. These disclosures are easily overlooked, or it is assumed that other disclosures included within the company's accounts meet the requirements. For example, companies are required to disclose the amount of revenue generated from each significant category of revenue recognised during the period, including revenue arising from the sale of goods and the rendering of services. For transactions involving the rendering of services, the accounting policy needs to include the methods adopted to determine the stage of completion.



5 Going concern issues

Going concern status

For companies in areas of the world that continue to experience difficult economic conditions, the assumption that the business is a going concern may not always be clear-cut. Management may therefore need to make careful judgements relating to going concern.

Management needs to ensure that it is reasonable for them to conclude that it is appropriate to prepare the financial statements on a going concern basis. IAS 1 'Presentation of Financial Statements' (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.

Regulatory guidance

The UK's Financial Reporting Council (FRC) has released 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009' (www.frc.org.uk).

The guidance may be relevant to management operating in those areas of the world that are faced by uncertain economic conditions when making financial announcements, in particular on how to reflect uncertainties facing their business. 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.

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 financial statements 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 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 true and fair view are still required, meaning that the directors need to explain why they consider 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 regarding 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, directors should build in extra time to consider this.

6 Foreign currency translation

Key application issues

IAS 21 'The Effects of Changes in Foreign Exchange Rates' is a long-established standard but continues to pose challenges in its application. Regulators have challenged companies where it appeared that IAS 21's requirements had not been met. Key application issues arise regarding:

- translation of foreign operations, in particular results for the period
- cash flow statements
- goodwill and fair value adjustments
- change of presentation currency.

Each of these is considered in turn below.

Translating foreign operations

A foreign operation is defined in IAS 21 as an entity that is a subsidiary, associate, joint venture or branch of a reporting entity, the activities of which are based or conducted in a country or currency other than those of the reporting entity. Where a foreign operation has a different functional currency, its financial statements need to be translated into the parent's presentation currency for consolidation.

IAS 21 requires monetary and non-monetary assets and liabilities to be translated at the closing rate and income and expense items to be translated at the rates ruling on the dates of the transactions. For practical reasons, IAS 21 permits a rate that approximates to the exchange rates on the dates of transactions to be used, for example an average rate for the period. However, IAS 21 states that this is inappropriate if rates fluctuate significantly. Therefore, where an average rate is used, it is essential to ensure that this is a reasonable approximation to the actual rates on the dates of transactions. Where rates fluctuate significantly, it may be necessary to revise the average rate used, for example to a monthly average rate.

All exchange differences are recognised in other comprehensive income until disposal of the foreign operation, when they are reclassified to profit or loss as part of the disposal.

Foreign operations in the cash flow statement

Exchange differences have no cash flow effect and therefore are not included in the consolidated cash flow statement. Regulators have acted against companies that have incorrectly included exchange differences in their cash flow statements.

Where the opening net assets include foreign currency cash and cash equivalents, the exchange difference arising on their retranslation at the closing rate for the current period will have been reflected in the closing balances. Such translation differences should be reported separately in the cash flow statement to arrive at the total movement in cash and cash equivalents in the period. This is in accordance with the requirements of IAS 7 'Statement of Cash Flows' (IAS 7.28).

In addition, translation of a foreign operation's monetary and non-monetary assets and liabilities into the presentational currency of the parent has a consequential effect on the amount of working capital changes reported as part of the reconciliation of cash flows from operating activities using the indirect method. Translation of income and expense items at the rate ruling at the date of the transaction has a consequential effect on the amount of non-cash items reported as part of the same reconciliation such as depreciation, amortisation and provisions.

Goodwill and fair value adjustments

IAS 21.47 requires any goodwill arising on the acquisition of a foreign operation and any fair value adjustments to the carrying amounts of assets and liabilities arising on the acquisition of that foreign operation to be treated as assets and liabilities of the foreign operation. Therefore they should be expressed in the functional currency of the foreign operation and translated at the closing rate in accordance with IAS 21.39 and 42. Regulators have acted against companies that did not comply with this requirement.

Change of presentation currency

IAS 21 permits an entity to present its financial statements in any currency. If the presentation currency is not the same as the functional currency, ie the currency of the primary economic environment in which the entity operates, then the translation into the presentation currency follows the same approach as translating foreign operations (Section 6). An entity may change its presentation currency but, if it does so, this is a change of accounting policy. Thus, IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' requires retrospective application of the new policy.

Where a group changes the presentation currency used in its consolidated accounts, as a change in accounting policy, this will result in restatement of prior periods. This will include tracking the cumulative translation differences arising from the translation of foreign operations, as IAS 21 requires such differences to be reclassified from equity to profit or loss on disposal of the foreign operation. This is likely to be a cumbersome process and therefore changing the group presentation currency needs to be considered carefully.

7 Financing: Issuing equity in settlement of debt

Debt-for-equity swap or debt waiver?

Adverse economic circumstances in some areas of the world have resulted in many companies seeking to restructure their finances by issuing equity shares to lenders in settlement of debt such as bank loans. Such transactions are often called 'debt-for-equity swaps.'

Treatment under IFRS

The IFRS Interpretations Committee issued IFRIC 19 'Extinguishing Financial Liabilities with Equity' Instruments in November 2009. Although IFRIC 19 is not mandatory until annual periods commencing on or after 1 July 2010, earlier application is permitted. If an entity reporting under IFRS is currently developing an accounting policy in this area, IFRIC 19 is likely to be highly persuasive when applying the principles in IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors'.

The key IFRS requirement that IFRIC 19 interprets is paragraph 41 of IAS 39 'Financial Instruments: Recognition and Measurement'. This 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 key requirements

IFRIC 19 requires that:

- the issue of equity instruments to a creditor to extinguish all or part of a financial liability is treated as consideration paid in accordance with IAS 39.41
- 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 extinguished and the consideration paid is recognised in profit or loss under IAS 39.41 and disclosed either as a separate line item in arriving at profit or loss or in the notes.

If only part of a financial liability is extinguished, IFRIC 19 requires the entity to assess whether some of the consideration paid relates to a modification of the terms of the remaining liability. If so, the consideration needs to be allocated between the part extinguished and the part that remains. For the latter, IAS 39's requirements on debt modification need to be applied and the key issue is whether the modification is substantial (see Section 8).

Prior to the publication of IFRIC 19, there was significant diversity in practice in accounting for debt-for-equity swaps. Some entities accounted for the liability extinguishment by measuring the equity instruments at their fair value, whilst others measured the equity instruments issued by reference to either the carrying value or the fair value of the liabilities extinguished. Measurement of the equity instruments at the carrying value of the financial liabilities extinguished meant that no gain or loss was recognised. However, such a treatment was not generally considered appropriate where the substance of the transaction was a debt waiver.

Scope of IFRIC 19

IFRIC 19 addresses only the accounting by the debtor; it does not address the accounting by the creditor. In addition, IFRIC 19 does not apply where:

- the creditor is also a direct or indirect shareholder and is acting in its capacity as such
- the creditor and the entity are controlled by the same party or parties before and after the transaction and the substance of the transaction includes an equity distribution by, or contribution to, the entity
- extinguishing the financial liability by issuing equity shares is under the original terms of the financial liability.

8 Debt modifications and embedded derivatives

Why are these issues important?

Many companies have negotiated revised terms for their borrowings over the past few years. The accounting impact under IAS 39 'Financial Instruments: Recognition and Measurement' can be significant and depends on the precise nature of the changes made. Embedded derivatives also pose significant accounting challenges under IAS 39, which may take time to resolve and necessitate the involvement of specialists.

Debt modifications

In many cases, the restructuring of finances does not take the form of a debt-for-equity swap (see Section 7), but instead is a modification of existing loan terms with creditors. The accounting consequences of modifying the terms of an existing debt instrument will depend on the particular circumstances and can differ significantly (some reflecting a gain or loss, others not), depending on whether or not the modification is considered to be substantial under IAS 39.

To determine whether a modification is substantial or not, the 10% test prescribed in IAS 39.AG62 is applied. This test requires the entity to compare the present value of the revised cash flows, plus any fees or costs paid, to the present value of the remaining cash flows of the original debt. Both are discounted at the instrument's original effective interest rate. Where the difference between the two present values is greater than 10%, the modification is considered a substantial modification in terms. Qualitative factors should also be considered when determining whether or not a modification is substantial. For example, a change in the currency of denomination of the debt might be regarded as substantial, even if the change in present value is less than 10%.

Extinguishment accounting is applied to a substantial modification. This involves the transaction being accounted for as a repurchase of the existing loan and recognition of a 'new' loan. The 'new' loan is recorded initially at fair value. This means that a gain or loss equal to the difference between the carrying value of the 'old' liability and the fair value of the 'new' liability is recognised immediately in profit or loss.

If the 10% threshold is not met and the modification is not considered to be qualitatively substantial, IAS 39 permits (but does not require) modification accounting to be applied. Where modification accounting is applied, either no gain or loss is recognised and the impact of the modification is amortised over the remaining term of the liability (IAS 39.AG62), or a gain or loss is recognised based on the re-estimation of cash flows applying the original effective interest rate (IAS 39.AG8).

Embedded derivatives

The increasing complexity of financial transactions has led to an increased use of both stand-alone derivatives and derivatives which are embedded in financial (and non-financial) host contracts. Stand-alone derivatives are those that are contractually transferable separately from another instrument and are always carried at fair value though profit or loss, unless hedge accounting applies (see Section 9).

However, derivatives are often embedded in a host contract in such a way that they are not contractually transferable from the host and as a result are often difficult to identify. They are normally designed to transfer some financial risks between the parties to the contract and are best identified by considering those clauses in a contract

which have the potential to modify the contractual cash flows. For example:

- foreign currency denominated sales and purchase contracts
- early repayment or extension options within debt instruments
- lease contract clauses requiring payments linked to an index.

Embedded derivatives are separated from the host and are accounted for at fair value through profit or loss when their economic characteristics and risks are not closely related to those of the host contract (the 'closely-related test'). Input from specialist valuers may be needed to determine the fair value of the derivative at each reporting date. The detailed requirements for determining whether or not an embedded derivative is closely related to the host contract are set out in IAS 39.AG30-AG33.

When embedded derivatives are closely-related to the host, they are accounted for as part of the host instrument. For example, the impact of a closely-related prepayment option is taken into account when estimating future cash flows of a debt instrument under the effective interest method when determining the instrument's amortised cost.

In certain circumstances, an entity can designate an entire hybrid instrument (host and embedded derivative) at fair value through profit or loss. Similarly, where it is not possible to measure an embedded derivative separately from the host, the entire hybrid instrument is designated at fair value through profit or loss.

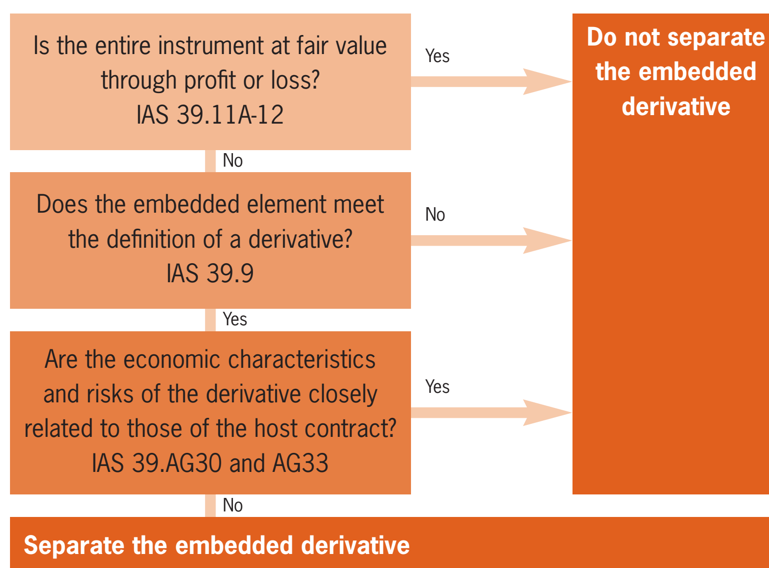
One of the most common types of embedded derivative that is not closely related under IAS 39 is an equity conversion feature in a convertible debt contract, from the perspective of the holder.

An equity conversion option is not generally closely related to the host debt and thus, from the holder's perspective, the instrument will usually comprise a loan asset and a separable embedded derivative asset for the conversion option.

From an issuer's perspective the equity conversion option may meet the IAS 32 'Financial Instruments: Presentation' definition of equity and thus give rise to a compound instrument, provided the IAS 32.16 'fixed-for-fixed' test is met. If this test is not met, the conversion option will give rise to an embedded derivative liability from the issuer's perspective.

The identification, separation and valuation of embedded derivatives can be time consuming and costly. It is advisable to consider their impact early in the reporting cycle to avoid any delays further down the line.

Illustration of thought process:



9 Hedge accounting

Why use hedge accounting?

Hedge accounting under IAS 39 'Financial Instruments: Recognition and Measurement' is a useful tool in mitigating the profit or loss volatility that would otherwise arise in accounting for derivatives at fair value through profit or loss, for example as a result of fluctuations in foreign exchange rates. It departs from the default principles in IAS 39 in order to match the offsetting effects on profit or loss of gains and losses on the hedging instrument and the hedged item.

Hedge accounting – is it required or optional?

Hedge accounting is purely optional and is permitted only where stringent conditions in IAS 39 are met. It would be incorrect to assume that, because a hedge appears to be a sound economic hedge, it necessarily qualifies for hedge accounting and also incorrect to assume that hedge accounting will avoid all related volatility in profit or loss. There are three types of hedge that may qualify for hedge accounting under IAS 39:

- cash flow hedges
- fair value hedges
- hedges of a net investment in a foreign operation.

The criteria necessary for hedge accounting include requirements for the formal designation and documentation of the hedging relationship and the hedge effectiveness testing to be applied. The requirements must be met at the inception of the hedging relationship and throughout its life. If one of the criteria is no longer met, hedge accounting must be discontinued.

The timing of this documentation and effectiveness testing is important. The hedge documentation must be completed at the hedge inception. That hedge documentation will need to set out various matters and decisions as described below. Hedge effectiveness is also described below, and in summary two forms of effectiveness tests, being prospective and retrospective tests, will need to be carried out at regular times. Effectiveness tests are typically required at hedge inception and at all interim and year-end reporting dates. Failure to meet those requirements will negate the availability of hedge accounting under IAS 39 (even if the hedge appeared perfect economically). A key message is therefore that if hedge accounting is planned, action is needed on a time critical and regular basis.

Hedge effectiveness

To qualify for hedge accounting, a hedge must be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated. Effectiveness must be tested prospectively at inception and thereafter both prospectively and retrospectively, at a minimum, each time an entity prepares its annual or interim financial statements. Where a hedge fails the effectiveness test, hedge accounting should be discontinued from the date effectiveness was last demonstrated.

IAS 39 does not prescribe particular methods of assessing effectiveness. However, as noted below, the testing methods to be used must be set out in the formal documentation supporting the hedge accounting designation. The actual results of the hedge effectiveness testing need to demonstrate that the gain or loss on the hedging instrument is within a range of 80% to 125% of the corresponding loss or gain on the hedged item.

Even if the hedge is highly effective, the ineffective element must always be recognised in profit or loss. It is not correct to assume that the hedge is always 100% effective just because critical terms match. There are many ways in which ineffectiveness arises. For example:

- if the hedged items are highly probable sales, then it is unrealistic to assume that the customer will always pay on exactly the same day as the related hedging instrument matures
- if the hedge relationship commenced after the derivative hedging instrument had been entered into, then this would create ineffectiveness
- at inception of a cash flow hedge, an interest swap (pay fixed/receive variable) will often have exactly matching terms to a variable rate loan (the hedged item). However, if at any time in the future the terms no longer match (eg through loan repayment) this may create ineffectiveness

Hedging documentation

Formal documentation is required at the inception of the hedge and cannot be backdated. If hedge documentation is not in place, hedge accounting is not permitted under IAS 39. The documentation is required to set out the following:

- a clear description of the hedged item and hedging instrument
- the risk management objective for carrying out the hedge
- the nature of the risk being hedged
- the methods to be used in assessing effectiveness, including frequency of the tests.

Discontinuance of hedge accounting

Hedge accounting should be discontinued prospectively if one of the following occurs:

- the hedging instrument expires or is sold, terminated or exercised
- the hedge no longer meets the criteria for hedge accounting (for example the hedge no longer meets effectiveness requirements)
- the forecast transaction is no longer expected to occur
- the entity revokes the designation.

The effect of discontinuance of hedge accounting is that future fair value changes of the hedged item and any hedging instruments are accounted for as they would be without hedge accounting. However, a revised effective interest rate is calculated when fair value hedge accounting ceases for a debt instrument.

On a discontinuance of a cash flow hedge:

- the cumulative gain or loss on the hedging instrument that had been recognised in other comprehensive income from the period when the hedge was effective remains in equity until the forecast transaction occurs
- if the transaction is no longer expected to occur, the cumulative gain or loss that had been recognised in other comprehensive income is reclassified immediately from equity to profit or loss as a reclassification adjustment.

10 Financial instruments disclosures

Financial instruments disclosure

IFRS 7 'Financial Instruments: Disclosures' sets out extensive disclosure requirements in relation to financial instruments and has been effective since 2007, although it has been amended several times since. Financial instrument disclosures are often highly significant to users of the financial statements but, given the continued economic uncertainties, they have an even greater significance at present. The 2009 amendments to IFRS 7 were intended to ensure that companies explained more clearly how they determined the fair value of financial instruments and to improve the disclosure of liquidity risk. These changes presented additional compliance challenges in 2009.

Common disclosure issues

Regulators have commented on some common areas where disclosures need to be improved. These include:

- analysis, by class of financial asset, of the age of the financial assets that are past due but not impaired at the balance sheet date
- maturity analysis for financial liabilities showing the remaining contractual maturities and describing how the company manages inherent liquidity risk
- a sensitivity analysis in respect of each type of market risk to which the company is exposed at the end of the reporting period.

These areas are considered in more detail below. In addition, regulators have noted that a number of companies use hedge accounting under IAS 39 'Financial Instruments: Recognition and Measurement' (see Section 9) but fail to disclose various information supporting aspects of hedge accounting which are required by IFRS 7.

Financial assets past due but not impaired

IFRS 7 requires an entity to disclose financial assets that are past due but not impaired. 'Past due' means a financial asset where the counterparty has failed to make payment when contractually due. This would, for example, include slow-paying trade receivables. Entities are required to disclose an ageing of financial assets past due at the balance sheet date but not impaired. This disclosure is not the same as an analysis of ageing of receivables (which would also include those not past due).

Maturity analysis (financial liabilities)

For the maturity analysis, IFRS 7 requires an entity to disclose:

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

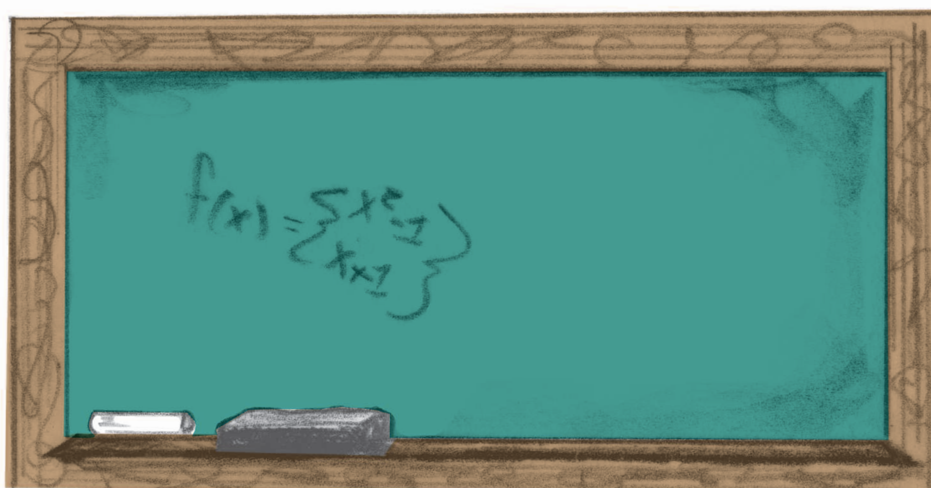
c a description of how the entity manages the liquidity risk inherent in (a) and (b).

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 maturity analysis should cover all non-derivative financial liabilities (including trade payables), derivative financial liabilities that are essential to an understanding of the timing of cash flows and items outside the scope of IAS 39 but within the scope of IFRS 7 (eg finance leases). The amounts included in the analysis should be the contracted, undiscounted cash flows. Hence, the figures often will not equal those in the balance sheet, which will either be fair values or, more commonly, amortised cost. Time periods should be analysed according to the earliest date on which the entity could be required to pay, and set out in time bands appropriate to the entity. For example, annual time bands may not provide sufficient granularity for the information on maturity of short-term liabilities to be useful to readers of the accounts.

Sensitivity analysis

IFRS 7.40 requires that sensitivity analysis be disclosed for each type of market risk (interest rate risk, foreign exchange risk and other price risks, for example commodity price risk). The sensitivity analysis needs to show separately both the effect on profit and on equity that would occur if there were a reasonably possible change in the underlying index. This disclosure requires comparatives. The standard also requires the methods and assumptions used in performing the sensitivity analysis to be disclosed.



Other areas for improvement

A key aspect of the 2009 amendment to IFRS 7 requires entities to classify financial instruments carried at fair value into a fair value hierarchy according to the levels of inputs into the measurement of financial instruments at fair value. 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).

This disclosure requirement applies to all financial instruments carried at fair value. This includes available-for-sale financial assets measured at fair value as well as financial assets and financial liabilities at fair value through profit or loss. The extent of disclosure required depends on the inputs to the fair value measurement. At its simplest, fair value is measured directly using a quoted market price. However, it might be measured using a valuation model with various inputs, depending on the financial instrument in question. The more detailed disclosure is required for instruments at fair value where the inputs to the fair value measurement are not based on observable market data. Companies that have financial instruments held at fair value need to consider carefully what inputs are used in measuring fair value and therefore where the instrument sits within the hierarchy.

Common errors in the first year of providing these disclosures included misclassifying instruments between levels and including the fair value of instruments carried at amortised cost in the hierarchy disclosures, whereas such instruments should be excluded.

In the first year of application of the new requirement, there was an exemption from providing comparatives (NB IFRS 7 was amended in 2010 to extend this relief to first-time adopters). As existing IFRS preparers will now be in their second year of providing these disclosures, that exemption no longer applies, so comparatives will be required.

Disclosures – Transfers of Financial Assets

'Disclosures – Transfers of Financial Assets (Amendments to IFRS 7)' was published in 2010. It introduces additional disclosures designed to help users evaluate the risk exposures relating to more complex transfers of financial assets and the effect of those risks on an entity's financial position. The Amendments are effective for annual periods beginning on or after 1 July 2011, with earlier application permitted.

11 Impairment

Impairment testing and disclosure
Impairment testing under IAS 36 'Impairment of Assets' continues to be an important issue for many businesses, whilst the disclosures made about the impairment testing in the financial statements are an area of ongoing scrutiny by regulators. The process followed in testing for impairment may be complex and involve significant judgement, whilst the disclosure requirements are extensive.

The impairment testing process
Identification of cash-generating units
A cash-generating unit (CGU) is defined in IAS 36 as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

The first step in the impairment testing process is the identification of the CGUs that make up the business, as these CGUs will form the basis of the impairment tests. In addition, IAS 36 requires disclosures to be made by CGU.

Allocation of assets to cash-generating units
The next step is that the assets of the business must be allocated to CGUs. This includes goodwill, which must be allocated to CGUs at least to the level of operating segments identified under IFRS 8 'Operating Segments'. The allocation of assets to CGUs gives the carrying value which will be compared to the recoverable amount in order to determine whether there is an impairment.

Identification of impairment indicators
The identification of impairment indicators is the third step in the process, in order to determine which CGUs will be tested for impairment.

CGUs to which goodwill or intangible assets with indefinite lives have been allocated, and intangible assets not yet available for use, are tested for impairment at least annually. Other CGUs are tested only when an indicator of impairment arises.

Calculation of recoverable amount
The recoverable amount of those CGUs that are required to be tested for impairment is then calculated. Recoverable amount is the higher of value in use and fair value less costs to sell.

Value in use is calculated using a discounted cash flow model, which requires key assumptions such as pre-tax discount rates and growth rates to be made for each CGU. Disclosure of these assumptions, together with information about how they have been determined, is required for each CGU.

Allocation of impairment losses
When the recoverable amount has been calculated, any impairment loss is allocated to the assets of the CGU. Impairment losses are first allocated to goodwill until goodwill is reduced to nil. Any remaining impairment losses are then allocated across the other assets of the CGU on a pro rata basis, although no individual asset should be reduced below its own recoverable amount.

Impairment testing disclosures

IAS 36 requires extensive disclosure of information relating to different stages of the impairment process. The required disclosures should be given by CGU. In addition, there may be significant judgements, such as in the identification of CGUs, or key sources of estimation uncertainty arising from the impairment testing, which should be disclosed under IAS 1 'Presentation of Financial Statements' (see Section 3).

Discount rates and growth rates

The discount rates and growth rates used in calculating the recoverable amount of each CGU should be specific to the CGU and be disclosed. Where the same discount rates or growth rates are used for two or more CGUs, this may give rise to questions, in particular where those CGUs have performed differently historically or have different risk profiles, for example because they are in different geographic locations.

Significant changes in the discount rates or growth rates used compared to previous years should also be explained in the financial statements.

Approach to determining key assumptions

As well as disclosing the assumptions themselves, an explanation should be given as to how these have been determined. This should include the extent to which the assumptions reflect past experience or are consistent with external sources of information.

Period covered by budgets and beyond

The period over which the projected cash flows used in the impairment test are based on approved budgets or forecasts is required to be disclosed, with an explanation given where this exceeds five years. Assumptions should be disclosed for both the period covered by approved budgets and beyond this period.

The growth rate used to extrapolate beyond that period is then also required to be stated, and justification will be needed where this is higher than the long-term average growth for the products, industry or country in which the CGU operates.

Sensitivity disclosures

Where there is no impairment loss for a CGU, but the impairment test shows that there is little headroom such that a reasonably possible change in a key assumption would result in an impairment, IAS 36 requires additional disclosures to be made. These include the amount of headroom on the impairment test for that CGU, the value assigned to the key assumption and the amount by which that assumption would need to change in order for the recoverable amount to be equal to the carrying amount of the CGU.

12 Share-based payment

IFRS 2 changes: cash-settled awards in groups

IFRS 2 'Share-based Payment' has been amended for periods beginning on or after 1 January 2010 to include guidance on accounting for cash-settled awards in group situations. At the same time, IFRS 2 has also been amended to incorporate two interpretations: IFRIC 8 'Scope of IFRS 2' and IFRIC 11 'IFRS 2 – Group and Treasury Share Transactions'. The incorporation of these IFRICs has not changed the accounting treatment, and therefore this section considers only the new guidance on cash-settled awards in groups.

A parent may grant to employees of a subsidiary a cash award which is based on the share price either of the subsidiary or of the parent itself. The amendment to IFRS 2 clarifies that such awards are share-based payment transactions, and deals with the accounting in the individual accounts of each company. From the perspective of the group in its consolidated accounts, the award is a straightforward cash-settled share-based payment.

Accounting treatment in the subsidiary

The employees receiving the award work for the subsidiary. Therefore the subsidiary is receiving the services under the share-based payment and, following the principle of IFRS 2, the subsidiary recognises the share-based payment charge in profit or loss.

The subsidiary has no obligation to settle the award, as the award has been granted by the parent and the parent will settle with the employees. As the subsidiary has no obligation, it accounts for the award as equity-settled. This treatment effectively considers the award to be a capital contribution from the parent company to the subsidiary.

Accounting treatment in the parent company

The parent company has the obligation to settle the award in cash with the employees of the subsidiary. Therefore the parent company recognises a liability. The debit entry in the parent company is not specified in the standard. This is typically recognised as an increase in the investment in the subsidiary, which again is consistent with the treatment of the award as a capital contribution to the subsidiary.

Measurement issues

As the subsidiary recognises the award as an equity-settled share-based payment, the share-based payment charge is based on the fair value of the award at the date of grant.

This will give a difference in measurement compared to the parent company, which measures its obligation as a cash-settled share-based payment, calculating the fair value of the liability at each balance sheet date.

IFRS 2 disclosure issues

Regulators have noted that share-based payment disclosures are sometimes poor in terms of content, extent and usefulness and may challenge them.

13 Segment reporting

Identification of segments

Under IFRS 8 'Operating Segments', segments are identified on the basis of the information reported to the Chief Operating Decision Maker (CODM) which is used to make operating decisions about the business.

If a group reports only a single segment in its operating segments disclosure, but narrative in the management commentary indicates that the group has diverse businesses or operates in a variety of geographic locations, this will bring into question whether the single segment disclosed is appropriate. If management commentary accompanying the financial statements discusses different businesses or identifies managers of different business streams, then this implies that this is how the group is managed and therefore the expectation is that information about these different businesses is reported to the CODM. Regulators have questioned companies about the disclosure of a single segment in these circumstances.

IFRS 8 terminology

IFRS 8 replaced IAS 14 'Segment Reporting' for periods beginning on or after 1 January 2009. In the first year of applying IFRS 8, many groups have continued to give their segment disclosures using IAS 14 terminology such as primary and secondary segments, and business and geographic segments.

A simple way to improve segment disclosure is to make sure that IFRS 8 terminology is used. This means that disclosure is given about the operating segments identified based on information reported to the CODM, with additional entity-wide disclosures also given about major customers, products and services and geographic locations.

Segment disclosures

The results and balances that IFRS 8 requires to be disclosed for each operating segment are those which are actually reported to the CODM. This means that they will not necessarily be under IFRS.

If the management commentary gives financial information or key performance indicators based on non-GAAP measures, then this suggests that management monitors the business and makes decisions on the basis of these non-GAAP figures. Therefore the operating segments disclosure in the notes to the financial statements would also be expected to be of non-GAAP information. Again, regulators have challenged companies when the segment disclosures are given using IFRS information and this is inconsistent with the information given in management commentary. If information is reported to the CODM on a basis other than IFRS, then the figures reported to the CODM for the total of the operating segments are required to be disclosed and reconciled to the IFRS figures in the primary statements.

Only one operating segment

Some groups do only have one reportable operating segment under IFRS 8. However, they still need to make disclosures required by that standard.

Entity-wide disclosures

In addition to operating segment disclosures, IFRS 8 requires entity-wide disclosures giving information about products and services, geographic locations and major customers to be given. These apply to all entities subject to IFRS 8, including those that just have one reportable segment:

- revenues from external customers for each product and service
- revenues from external customers attributable to the entity's country of domicile and to all foreign countries in total (including the basis of attributing revenues to individual countries). If revenue amounts are material for an individual country this is disclosed separately
- certain non-current assets located (i) in the entity's country of domicile and (ii) located in all foreign countries in total in which the entity holds assets. If the assets are material for an individual country, these need to be disclosed separately.

The amounts reported in the entity-wide disclosures are IFRS-based figures, not those used for internal reporting. This disclosure is required regardless of whether management uses this information to make operating decisions. Exemption is available only if the information is not readily available and would cost excessive amounts to obtain, in which case this fact should be disclosed.

If revenues from a single external customer amount to 10% or more of total revenue, IFRS 8 requires that fact to be disclosed together with the total amount of revenue for each such customer. However, the name of the customer need not be stated.

No seriously prejudicial exemption

IFRS 8 does not contain any exemption from any of its disclosures, not even due to the information being considered to be commercially sensitive or seriously prejudicial to the group's operations. Some regulators have acted in relation to this, and have made it clear that the disclosures required by IFRS 8 are required even if management consider this to be seriously prejudicial to their business.

14 Earnings per share

Presentation requirements of IAS 33

IAS 33 'Earnings per Share' requires presentation in the statement of comprehensive income (or separate income statement, if presented) of both basic and diluted earnings per share (EPS) for:

- profit or loss from continuing operations attributable to the ordinary equity holders of the parent entity, and
- total profit or loss attributable to the ordinary equity holders of the parent entity.

Basic and diluted EPS for profit or loss from discontinued operations attributable to the ordinary equity holders of the parent entity are presented either in the statement of comprehensive income (or separate income statement) or in the notes to the financial statements.

Basic and diluted EPS should also be presented for each class of ordinary shares that has a different right to share in the profit for the period.

Calculation of earnings per share

Basic EPS is calculated by dividing the profit or loss attributable to ordinary shareholders of the parent by the weighted average number of ordinary shares outstanding in the period.

In order to calculate diluted EPS, the profit or loss attributable to ordinary shareholders and the weighted average number of shares outstanding are adjusted for the effects of all dilutive potential ordinary shares. The calculation of diluted EPS in particular can be complex, leading to problems in practice. The remainder of this section therefore focuses on the calculation of diluted EPS, in particular where options or warrants are involved.

What are dilutive potential ordinary shares?

A potential ordinary share is defined in IAS 33 as a financial instrument or other contract that may entitle its holder to ordinary shares. Examples of potential ordinary shares therefore include:

- shares to be issued under equity-settled share-based payment arrangements
- convertible instruments such as convertible preference shares or convertible loans
- other share options and warrants for the purchase of shares.

A potential ordinary share is dilutive when, and only when, its conversion to ordinary shares would decrease EPS or increase loss per share from continuing operations.

Diluted earnings per share and share-based payments

IAS 33 requires that the exercise of all dilutive options and warrants of the entity is assumed for the purpose of calculating diluted EPS. However, it is not as simple as taking the total number of shares that may be issued under such arrangements and adding this to the weighted average number of shares in issue.

Options and warrants are dilutive when they would result in the issue of ordinary shares for less than the average market price of the ordinary shares during the period. To calculate diluted EPS, the exercise of all dilutive options and warrants is assumed. The assumed proceeds of exercise are regarded as having been received from the issue of ordinary shares at the average market price during the period, with the remainder of the potential ordinary shares being regarded as issued for nil consideration. This means that in calculating diluted EPS, potential ordinary shares are treated as consisting of the following:

- a contract to issue a certain number of shares at their average market price during the period. These ordinary shares are then considered to be fairly priced and are neither dilutive nor anti-dilutive, and are ignored in the calculation of diluted EPS
- a contract to issue the remaining ordinary shares for no consideration. These shares are dilutive and are added to the number of ordinary shares outstanding in the calculation of diluted EPS.

Options and warrants will have a dilutive effect only if the average share price in the period is higher than the exercise price of the options or warrants.

The control number

Profit or loss from continuing operations attributable to the parent company is used as the control number in order to establish whether potential ordinary shares are dilutive or anti-dilutive.

This means that if a group is loss-making overall, but has profitable continuing operations and potential ordinary shares are dilutive of EPS for continuing operations, then those potential ordinary shares are also applied in calculating diluted loss per share from discontinued operations and from the overall loss, even though they are anti-dilutive to those amounts.

15 Management commentary

The IASB's Practice Statement

In addition to preparing financial statements in accordance with the requirements of IFRS, management may also be required to present additional accompanying commentary as a result of local legislation or may wish to do so voluntarily in order to provide the user with useful information.

With this in mind, the IASB has published its first IFRS Practice Statement 'Management Commentary – A framework for presentation'. The Practice Statement provides a broad, non-binding framework for the presentation of management commentary that relates to financial statements prepared in accordance with IFRSs. Management commentary denotes a narrative report relating to IFRS financial statements. Such reports provide users with

- explanations of the amounts presented in the financial statements
- commentary on the entity's prospects and other information not presented in the financial statements
- a basis for understanding management's objectives and strategies.

The authority of the Practice Statement

The Practice Statement is not an IFRS and therefore does not have the same authority as an IFRS. It does not mandate which entities are required to publish management commentary, how frequently they should do so or the level of assurance to which management commentary should be subjected.

The framework for preparation of management commentary

Rather than mandating the inclusion of certain information, the Practice Statement establishes a principles-based framework for preparing management commentary. Management should present commentary that is consistent with the following principles:

- to provide management's view of the entity's performance, position and development
- to supplement and complement information presented in the financial statements.

In relation to supplementing and complementing the financial statements, management commentary should, in addition to discussing the factors which have led to the amounts presented in the current financial statements, discuss forward-looking information. The Practice Statement acknowledges however that the extent of forward-looking information will be influenced by the regulatory and legal environment within which the entity operates.

Elements of management commentary

Being principles-based, the Practice Statement acknowledges that the particular focus of management commentary will depend on the facts and circumstances of the entity in concern. It does however indicate that management commentary should include information on the following elements:

- the nature of the business (eg the entity's main markets, its main products or services, the legal and regulatory environment, etc)
- management's objectives and its strategies for meeting those objectives
- the entity's most significant resources, risks and relationships
- the results of operations and prospects (eg financial and non-financial performance and targets)
- the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

The flexibility afforded by the Practice Statement's principles-based approach should however reduce the risk of management adopting a 'boilerplate' approach to writing their reports. Care should however be taken to ensure that disclosures are specific to the entity's operations, that jargon is avoided and that the language is clear.

Interaction with local requirements

The IFRS Practice Statement should contribute to improved management commentary, particularly in those jurisdictions that do not already have well developed requirements in this area.

In jurisdictions that have existing requirements, however, the Practice Statement may provide useful guidance without necessarily being sufficient to ensure compliance with those local requirements.

16 Deferred Tax: Recovery of Underlying Assets

Amendments to IAS 12 Income Taxes

The IASB has published some limited scope amendments to IAS 12 'Income Taxes', which are relevant only when an entity elects to use the fair value model for measurement in IAS 40 'Investment Property'. The amendments will be significant in those jurisdictions in which rental income and capital gains or losses are taxed differently. The amendments introduce a rebuttable presumption that in such circumstances, an investment property is recovered entirely through sale.

SIC-21 'Income Taxes – Recovery of Revalued Non-Depreciable Assets' addresses similar issues involving non-depreciable assets measured using the revaluation model in IAS 16 'Property, Plant and Equipment'. This guidance has now been incorporated into IAS 12.

Recovery through sale presumption

Under IAS 12, the measurement of deferred tax liabilities and deferred tax assets in some tax jurisdictions depends on whether an entity expects to recover an asset by using it or by selling it. However, an entity may expect to rent out investment property to earn rental income and then sell it to gain from capital appreciation at some point in the future. Without specific plans for disposal of the investment property, it is difficult and subjective to estimate how much of the carrying amount of the investment property will be recovered through cash flows from rental income and how much of it will be recovered through cash flows from selling the asset. This is particularly so when the carrying amount is measured using the fair value model in IAS 40.

To provide a practical approach in such cases, the amendment introduces a presumption that an investment property is recovered entirely through sale. This presumption is rebutted if the investment property is held within a business model whose objective is to consume substantially all of the economic benefits embodied in the investment property over time, rather than through sale.

Consequential withdrawal of SIC 21 Income Taxes – Recovery of Revalued Non-depreciable assets

SIC-21 addresses issues involving non-depreciable assets measured using the revaluation model in IAS 16 'Property, Plant and Equipment', as well as investment property measured at fair value that is considered non-depreciable. The consensus requires that, where tax law specifies a different tax rate applicable to the taxable amount derived from the sale of an asset compared to the rate derived from its use, then the former rate applies. This requirement is now incorporated into IAS 12, after excluding investment property from its scope, and so SIC-21 is withdrawn.

Effective date

This amendment to IAS 12 is effective for annual periods beginning on or after 1 January 2012. Earlier application is permitted.

17 Amendments to IFRS 1 First-time Adoption of International Financial Reporting Standards

Two limited amendments made

The IASB has published two limited amendments to IFRS 1 'First-time Adoption of International Financial Reporting Standards'. The amendments:

- remove certain fixed dates in the Standard
- introduce an additional exemption for entities emerging from a period of severe hyperinflation.

The first amendment will reduce the cost and effort required to apply the detailed rules relating to some aspects of financial instrument accounting. The second amendment will provide much needed guidance and relief for those (relatively few) entities that have been affected by severe hyperinflation.

Removal of fixed dates

IFRS 1 already contained exemptions that allowed first-time adopters to apply the derecognition requirements and the 'day 1' gain or loss recognition requirements of IAS 39 'Financial Instruments: Recognition and Measurement' prospectively to transactions occurring on or after 1 January 2004. However, as time passes, this date becomes more remote and so it is increasingly costly for first-time adopters to reconstruct transactions back in time. Consequently, IFRS 1 has been amended to replace the date of 1 January 2004 with the date of transition to IFRSs. This will provide relief for first-time adopters of IFRSs from having to reconstruct transactions that occurred before their date of transition to IFRSs.

Additional exemption after a period of severe hyperinflation

In a period of severe hyperinflation, an entity cannot comply with IAS 29 'Financial Reporting in Hyperinflationary Economies' if a reliable general price index is not available to all entities with that same functional currency, and exchangeability between the currency and a relatively stable foreign currency does not exist.

IFRS 1 now provides guidance on how an entity can present IFRS financial statements after its currency ceases to be severely hyperinflationary. The entity may elect to measure its assets and liabilities at fair value, which could then be used as the deemed cost in its opening IFRS statement of financial position, presented on or after the functional currency normalisation date. This may lead to a comparative period of less than 12 months.

This amendment is available to entities that are emerging from a period of severe hyperinflation, whether or not they had applied IFRSs prior to the severe hyperinflationary period.

Effective date

These amendments to IFRS 1 are effective for annual periods beginning on or after 1 July 2011. Earlier application is permitted.

18 Detail counts…

Related party disclosures

Issues arising from related party disclosures and compliance with IAS 24 'Related Party Disclosures' have drawn comment from regulators. Whilst these issues do not affect accounting treatment, related party disclosures are often significant to readers of the financial statements, and thus should not be overlooked. Two key areas are discussed below.

Key management personnel compensation

IAS 24.16 requires disclosure of key management personnel compensation in total, split between:

- short-term employee benefits
- post-employment benefits
- other long-term benefits
- termination benefits
- share-based payment.

Key points that are easily overlooked include:

- key management personnel includes all directors, whether executive or non-executive, and may also include persons other than management of the parent company, such as leaders of key divisions within the group
- the IAS 24.16 disclosures focus on the cost recognised by the reporting entity rather than the benefit to the director or employee. This means the figures disclosed may not be the same as those provided in compliance with statutory directors' remuneration disclosures. For example, the share-based payment aspect of IAS 24.16 requires disclosure of the IFRS 2 'Share-based Payment' charge (or credit) for the year relating to key management personnel.

Dividends to management

Management may also be shareholders and therefore will receive any dividends paid on their shares. These dividends are related party transactions because members of management are related parties. Thus, if material, they need to be included in the related party transactions disclosures or otherwise disclosed. In straightforward cases, it may be possible that disclosure of management interests in shares and disclosure of the amount of dividends per share in the financial statements will be sufficient. However, where there have been significant changes in shareholdings or in the composition of management, reliance on this approach may not provide sufficient disclosure of related party transactions.

Capital disclosures

IAS 1 'Presentation of Financial Statements' requires disclosure of information that enables users of the financial statements to evaluate the entity's objectives, policies and processes for managing capital (IAS 1.134-136). Poor disclosure in this area is often commented on by regulators, both because disclosures are often boilerplate and uninformative and because the specific requirements of the standard are not met.

Good disclosure regarding capital management will be particularly important in difficult economic conditions, where companies may have to act to manage their capital base, for example by suspending dividends or issuing new shares. Such actions should be reflected in the capital management disclosures. In addition to the narrative disclosure of objectives, policies and processes for managing capital, IAS 1 requires disclosure of what the entity manages as capital, including summary quantitative data. This disclosure is frequently overlooked and is an area that regulators are likely to focus on.

Leases of land

In April 2009, the IASB published 'Improvements to IFRSs 2009'. This made amendments to a number of IFRSs, including IAS 17 Leases. The changes to IAS 17 are effective for annual periods commencing on or after 1 January 2010. The amendment removed the detailed guidance previously included in IAS 17 on classification of leases of land and buildings as operating or finance leases. Thus, the general lease classification principles apply equally to leases of land and buildings. The standard continues to require the land and buildings elements to be assessed separately.

The amended IAS 17 notes that an important factor in classifying the land element is that land normally has an indefinite economic life. Prior to the amendment, IAS 17 stated that the land element was normally classified as an operating lease, unless title passed at the end of the lease term. This statement has been removed from IAS 17. Thus, under the amended standard, a lease of land may be classified as a finance lease even if title does not transfer. This may lead to some reclassification of very long leases of land as finance leases where this reflects the substance of the lease. The IAS 17 amendments apply retrospectively.

Where an entity has long leases of land, it will be important to consider whether any of those leases should be reclassified as finance leases based on the general IAS 17 lease classification criteria. For example, even if title reverts to the lessor, that reversion may be so far into the future as to have little or no economic significance.

Provisions

Although IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' is a long-established standard, presentation and disclosure issues continue to arise and draw attention from regulators. Two key points to keep in mind are:

- provisions should not be combined with accruals or otherwise misdescribed in the financial statements. IAS 37.12 notes that provisions can be distinguished from other liabilities such as accruals because there is uncertainty about the timing or amount of the future expenditure required in settlement. Although it is sometimes necessary to estimate the amount or timing of accruals, the uncertainty is generally much less than for provisions
- IAS 37 sets out specific disclosure requirements for provisions, and requires that disclosures are given for each class of provision. Disclosures need to be sufficient for the reader to understand the nature, timing and amount of the outflows concerned.

19 What's on the way for 2011?

IFRS changes for 2011

No major new IFRSs become mandatory in 2011. However, several smaller changes take effect and have the potential to impact on 2011 financial statements. Those changes most likely to have an impact in practice are outlined below.

Related parties

IAS 24 (Revised 2009) 'Related Party Disclosures' is effective for annual periods commencing on or after 1 January 2011. The two main changes compared to the existing IAS 24 are:

- the introduction of disclosure exemptions for transactions with a government and government-related entities
- a revised definition of related parties, together with other smaller changes.

The revised definition is slightly broader and thus more transactions may need to be disclosed as related party transactions. For example, the revised definition explicitly includes as related parties of each other:

- two joint ventures of the same venturer
- a joint venture and an associate of the same investor/venturer (but not two associates of the same investor).

Debt-for-equity swaps

IFRIC 19 'Extinguishing Financial Liabilities with Equity Instruments' is effective for annual periods commencing on or after 1 July 2010. The key impact of this Interpretation is on the accounting for debt-for-equity swaps under IFRS. IFRIC 19 requires equity instruments issued to settle a financial liability to be measured at the fair value of the equity instruments issued unless that value is not reliably measurable (in which case the fair value of the financial liability extinguished is used instead). Gains or losses on settlement of a financial liability are recognised in profit or loss under IFRIC 19.

IFRIC 19 is covered in more detail in Section 7 as the issues it addresses are also relevant for 2010 accounts.

Improvements to IFRSs 2010

The 2010 edition of IASB's annual improvements to IFRS, 'Improvements to IFRSs May 2010', will impact on IFRS financial statements in 2011. Most changes become mandatory for annual periods commencing on or after 1 January 2011 but changes relating to IFRS 3 'Business Combinations' (Revised 2008) take effect for annual periods commencing on or after 1 July 2010.

The most notable changes are:

- clarifying the treatment of contingent consideration in business combinations that occurred prior to the adoption of IFRS 3 (Revised 2008). This is not adjusted on adoption of the revised standard
- amendments to IFRS 3 relating to share-based payments of the acquiree that the acquirer chooses to replace or does not replace
- amendments to IFRS 3 relating to measurement of non-controlling interest, restricting the option not to measure non-controlling interests at fair value to interests that are present ownership interests that entitle holders to a proportionate share of the entity's net assets in the event of a liquidation
- clarification of the IASB's intentions regarding presentation of reconciliations for each component of other comprehensive income under IAS 1 'Presentation of Financial Statements' (Revised 2007). These reconciliations may be in the statement of changes in equity or in the notes (see Section 3).

20 What's on the horizon?

IFRS is changing

The IASB has a heavy work programme to revamp major areas of IFRS over the next few years. Two of the most pervasive areas where new standards are on the way are revenue and leasing. These are considered further below. Other areas where major changes are on the way include financial instruments, consolidation and joint ventures. The IASB is currently consulting on effective dates for its new proposals, with 1 January 2013 a potential effective date for major changes. Though the changes may seem a long way off, the big changes will need to be considered well in advance. Some may even impact on how companies do business.

Revenue

The IASB and the US standard setter FASB have a joint project to develop a new standard on revenue recognition. An Exposure Draft of a proposed standard 'Revenue from Contracts with Customers' was issued in June 2010. As the title indicates, the contract is central to how revenue will be accounted for once the final new standard is in place. The new standard is expected to apply retrospectively, with restatement of comparatives. This means that any existing contracts in place at the start of the comparative period will be affected. That could be as early as 1 January 2012. The new standard will replace IAS 18 'Revenue', IAS 11 'Construction Contracts' and several IFRS Interpretations Committee interpretations.

The central principle is that revenue will be recognised not based on a supplier's activity but on the transfer of control of a good or service to the customer. That could have a significant impact on revenue from construction and services, for example. However, the new requirements are likely to affect how revenue is recognised by most businesses, so no one will be able to ignore the standard's potential impact.

Key scope exclusions from the proposed standard are leasing contracts, insurance contracts, financial instrument contracts and non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange (for example, swaps of similar items).

Leases

In August 2010, the IASB issued its long-awaited Exposure Draft (ED) 'Leases'. When issued as an IFRS, this will replace the present standard, IAS 17. The new standard will cover both lessees and lessors.

For lessees, the existing operating lease versus finance lease distinction will be scrapped and replaced by a single model based on rights of use. The central idea is that the lessee has acquired the right to use the underlying asset and is paying for that right with its rental payments. This means that the lessee will recognise a right-of-use asset and a corresponding liability for the obligation to pay rentals. Thus, all leases will be on the balance sheet of the lessee. The IASB is proposing some transitional reliefs but many existing leases will nevertheless need to be restated.

For lessors, the ED proposes two approaches depending on the exposure of the lessor to the risks and benefits of the underlying asset:

- where the lessor transfers the significant risks or benefits, the derecognition approach would apply, whereby all or part of the underlying asset would be derecognised and a right to receive lease payments recognised as an asset
- where the lessor retains exposure to significant risks or benefits of the underlying asset, the performance obligation approach would apply. The underlying asset would be retained on the lessor's balance sheet. An asset would be recognised for the right to receive lease payments and a liability would be recognised for the obligation to permit the lessee to use the asset. The net total of the three items would be presented as a single amount in the balance sheet, with disclosure of the components of that amount.

Key scope exclusions from the proposed standard are:

- contracts that are labelled as leases but are actually purchase or sale arrangements
- investment properties accounted for at fair value under IAS 40 'Investment Property': lessors will continue to apply the requirements in IAS 40
- biological assets: these will remain within IAS 41 'Agriculture'
- leases of intangible assets and leases to explore for or use minerals, oil, natural gas and similar non-regenerative resources: these are excluded until the accounting for such items can be considered more broadly.

Notes

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