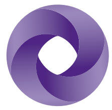

Grant Thornton

An instinct for growth™

2012 EDITION

IFRS Top 20 Tracker

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Executive summary

Introduction

The 2012 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 2011.

Key themes

Key themes driving selection of the issues in the 2012 edition are:

- the need for a company's management commentary and financial statements to complement and be consistent with each other
- the effect that adverse economic conditions may have on a company's financial statements, with particular emphasis on issues related to the Eurozone sovereign debt crisis
- key areas of interest for regulators
- 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 2012

1 Being consistent

The financial statements as a whole

Many companies that prepare their financial statements in accordance with IFRS are also required to prepare an accompanying management commentary (also described using other titles such as Management's Discussion and Analysis, Operating and Financial Review, and Directors' Report). The IASB has published its own non-mandatory Practice Statement in this area. In many countries local law and stock exchange regulation also set out narrative reporting and disclosure requirements that go beyond IFRS.

Complying with each of these requirements requires complete and accurate accounting information. The different requirements cannot be considered in isolation however. It is important that the management commentary and financial statements are considered as a whole, in order to ensure that they both complement and are consistent with each other.

The importance of consistency covers management commentary, the primary statements, the accounting policies and the notes to the financial statements. Where the different sections of the management commentary and financial statements are prepared by different people, or at different times, particular care will be needed to make sure that all of these elements fit together as a cohesive whole, avoiding repetition as far as possible.

Regulators question inconsistencies

Regulators will look for inconsistencies between information given in different parts of a company's management commentary and its financial statements. For example, is information given about the future outlook for the business consistent with disclosure about why the company is considered to be a going concern? (More information about the disclosure of going concern is given in Section 4.)

Regulators continue to focus on revenue recognition in general, with accounting policies for revenue recognition coming under intense scrutiny. It is important that a company's revenue recognition policies are consistent with information given about the nature of its business model in its management commentary.

Other areas where regulators have been known to question apparent inconsistency between management commentary and the financial statements, include impairment, going concern and operating segment disclosures.

Points to consider

We set out below some points to help management in achieving consistency in the management commentary and the financial statements:

- are a company's segment disclosures under **IFRS 8 'Operating Segments'** consistent with the way it describes its business and its management in the management commentary?
- are non-IFRS measures properly reconciled to IFRS disclosures where appropriate?
- are the assumptions used in an entity's impairment testing (for example estimates of future growth rates in estimating future cash flows) consistent with information disclosed in the management commentary?
- do the company's accounting policies cover the key types of revenue and other transaction information discussed in the management commentary and are they clear, relevant and complete?
- is the discussion of events after the reporting period in the management commentary consistent with the disclosures in the financial statements under **IAS 10 'Events after the Reporting Period'**?

2 Economic conditions and public spending cuts

Background

Businesses in many parts of the world continue to feel the impact of subdued global economic activity. The crisis in the Eurozone has in particular exerted a negative impact on growth, with companies (both in Europe and more widely) seeing revenue and profit growth weakening.

Economic conditions

The final quarter of 2011 saw a slowdown in growth in many European countries and talk of a return to recession in some.

There continues to be uncertainty over the prospects for economic recovery throughout the Eurozone and further afield, including major economies such as the USA. Economic growth remains slow and market conditions are challenging for many companies. As a result, the outlook for many businesses is uncertain, with pressure on margins and financing as well as weak demand for products and services.

Austerity measures

Many European governments have announced or are implementing austerity programmes. These measures have a direct impact on businesses' trade with the public sector and also affect wider economic drivers such as consumer confidence. For companies that do business with the public sector in affected countries, significant cuts will have an impact as the public sector seeks to find efficiencies in the provision of its services. Even companies that do not trade directly with the public sector may nevertheless be affected by the cuts, as they may, for example, be part of the supply chain.

Impact on management commentary

Management will need to assess the impact that these wider economic factors will have on the future outlook for their business. These assessments will affect the forward-looking components of management commentary. This will be a key part of making sure that management commentary and the financial statements complement and are consistent with each other, as discussed in Section 1.

Impact on areas of financial reporting

There are a number of areas of the financial statements that may be impacted where an entity is affected by adverse economic conditions and spending cuts, some of which are highlighted below. The areas impacted will vary depending upon the nature of the business concerned and the sector or industry in which it operates.

Going concern

Where a company is impacted adversely by economic uncertainty or by public spending cuts, this will need to be taken into account by management in assessing whether the business is a going concern. The assessment made should also be reflected in the disclosure about going concern made in the financial statements (discussed further in Section 4).

For example, a company that has significant balances outstanding, or business relationships, with the public sector in a country facing financial stress should probably disclose that fact and indicate the future events that could impact on amounts outstanding and future trading volumes. In such instances, consideration will also need to be given to additional going concern disclosures such as the key assumptions made by management as part of the going concern assessment.

As well as any impact on expected future revenues which will need to be considered in assessing going concern, other factors such as the availability of finance will need to be taken into account, in particular where facilities are due for renewal within 12 months of issue of the financial statements.

Impairment

Significant adverse changes in the economic environment or market in which a company operates are indicators of potential asset impairments. As a result, impairment testing will be required under **IAS 36 'Impairment of Assets'**, and impairment charges may result. Impairment testing is discussed in more detail in Section 9.

Fluctuations in foreign exchange rates may present issues in impairment testing, particularly for companies that trade with countries in the Eurozone. In calculating value in use under IAS 36, future cash flows should be included in the currency in which they will be generated and then discounted using an appropriate discount rate for that currency. The present value is then translated using the spot rate at the date of the value in use calculation.

Inventory write-downs may also be required under **IAS 2 'Inventories'**.

Use of derivatives to reduce exposure to market volatility

Management may seek to mitigate exposure to market volatility through the use of instruments such as forward contracts or interest rate swaps. Such instruments are derivatives in the scope of **IAS 39 'Financial Instruments: Recognition and Measurement'**, which requires recognition at fair value with movements taken to profit or loss. While the use of derivatives may reduce real exposure to risk, they may introduce income statement volatility.

There may be scope to apply hedge accounting under IAS 39. However, there are strict conditions which must be met in order for hedge accounting to be applied (Section 15). It is important to note that these conditions must be met at the outset, as formal designation and documentation of the hedging relationship needs to be in place at the inception of the hedge.

The requirements of **IFRS 7 'Financial Instruments: Disclosures'** are extensive and include disclosures about financial instruments at fair value and about hedge accounting.

Consequences of restructuring

A downturn in business may necessitate restructuring. Where a decision is made to sell or terminate part of the business, **IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations'** may become relevant. The requirements of IFRS 5 are discussed in Section 10.

Management will also need to consider whether a provision is required under **IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'** as a result of a decision to restructure the business. A provision may only be made where management has a constructive obligation to restructure; intent alone is not sufficient. A constructive obligation arises when there is a detailed formal plan in place for the restructuring and a valid expectation has been raised in those affected that the restructuring will be carried out. A restructuring may also include termination benefits, which are covered by slightly different rules in **IAS 19 'Employee Benefits'**.

3 Eurozone sovereign debt crisis

Background

In addition to the general challenges discussed in Section 2, the crisis in Eurozone sovereign debt gives rise to various accounting issues relating to financial instruments.

Banks in particular may have significant sovereign debt exposure and increased liquidity risks. However, banks are not the only entities affected. Other entities will also face increased country and currency risks. We summarise below a number of IFRS requirements that may need particular attention by management.

Eurozone sovereign debt holdings

Several European governments are experiencing financial difficulties, evidenced in some cases by bail-out actions and credit rating downgrades. This raises a question of whether sovereign debt issued by such governments is impaired in the financial statements of holders.

Put broadly, under **IAS 39 'Financial Assets: Recognition and Measurement'**, a financial asset or a group of financial assets is impaired if there is objective evidence of impairment that reduces the estimated future cash flows.

In our view there is objective evidence of impairment of Greek Government Bonds (GGBs) at 31 December 2011 and at the date of writing this publication. Accordingly, for GGBs classified as available-for-sale, impairment losses should reflect fair values at the period end. For GGBs classified as held to maturity or loans and receivables, impairment should reflect the latest expectations of a private sector contribution (or 'haircut'). New information as to the private sector involvement in restructuring, and whether it will go ahead, may impact measurement of GGBs at amortised cost.

At the date of writing, we do not believe impairment losses for other Eurozone sovereign debt are needed. An important difference between GGBs and other sovereign debt is that, in the latter case, there is no current expectation of a private sector haircut. However, new information (eg information about private sector involvement) may emerge before the date of approval of an entity's financial statements that may change this conclusion. If so, impairment would be recognised at that date.

Impairment of other financial assets

The current economic environment will also affect financial asset impairment more generally. Impairment losses need to be determined on a case by case basis reflecting the specific facts and circumstances. Some specific points to consider include:

- for debt type assets, objective evidence of impairment includes financial difficulty of the debtor, breaches of the terms of the instrument and it becoming probable that the debtor will enter bankruptcy or financial reorganisation
- for investments in equities, a significant or prolonged decline in fair value to below cost is one type of objective evidence of impairment
- for available for sale assets, if objective evidence of impairment exists the entire decline in fair value that has been recognised in other comprehensive income is reclassified into profit or loss.

Effect of Eurozone sovereign debt crisis on discount rates

As well as the effect on financial asset impairment discussed above, the Eurozone sovereign debt crisis may affect companies more generally as a result of its effect on discount rates.

Where an asset-specific rate is not directly available, it is typical to estimate the discount rate by using the Capital Asset Pricing Model (CAPM) to calculate the entity's weighted average cost of capital. Key components of the CAPM are a risk-free rate of return (usually estimated by reference to a government security), a market risk premium, and a Beta factor (representing sensitivity to market movements).

The Eurozone sovereign debt crisis has increased the yield on long-dated government bonds in what are perceived as the weaker countries in the Eurozone, while decreasing the yields on the government bonds of those countries that are perceived as being safe havens. Putting this information into the CAPM may result in a significant increase in the discount rate to be used for the impairment testing of some assets and cash generating units. This together with reduced expectations of future cash flows may result in higher levels of impairment for some companies.

Disclosure about risks and uncertainties

IAS 1 'Presentation of Financial Statements' contains a disclosure requirement in relation to the sources of estimation uncertainty in the carrying amount of assets and liabilities (IAS 1.125). The current economic environment will lead to many examples of increased estimation uncertainty. Entities must disclose information about assumptions and other major sources of estimation uncertainty that have a significant risk of resulting in material adjustments in the following year. For example, impairment of sovereign debt from a particular country with financial challenges may not be required, but disclosure of the amounts outstanding would be appropriate (IAS 1.125-133).

This disclosure will be influenced by the assessment of material country and/or currency risks faced by each entity, the underlying assumptions about a reasonable range of potential outcomes, and how such different circumstances might affect the value of the relevant assets and liabilities.

IFRS 7 'Financial Instruments: Disclosures' requires extensive disclosure in relation to financial instruments and related risks. Examples include detailed disclosures about risk concentrations, credit risk, liquidity risk and other market risks and how those risks are managed. Management needs to consider the impact of economic conditions on such disclosures. For European banks meaningful liquidity disclosures and information on capital management, funding requirements, contingencies and stress tests are likely to be of particular importance.

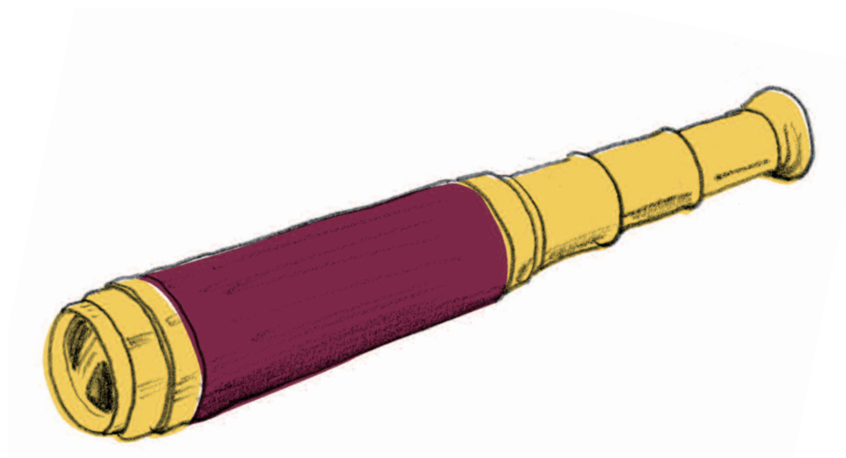
Events after the reporting period

The macro-economic situation in many countries, and the circumstances of specific companies, may change rapidly in the current environment. This will increase the prevalence of material events after the reporting period affecting companies' financial statements. **IAS 10 'Events after the Reporting Period'** classifies events after the reporting period into those that provide evidence of conditions that existed at the end of the reporting period (adjusting events) and those that do not (non-adjusting events). Particular attention may need to be paid to the identification and analysis of such events in the current circumstances.

Going concern – Specific considerations for banks

IFRS also requires management to make an assessment of the entity's ability to continue as a going concern (see section 4). For banks, particularly in the Eurozone, a number of specific factors will impact the going concern assessment. These factors include:

- the general tightening of credit and liquidity that has been observed in the Eurozone
- the sovereign debt issues referred to above, along with broader macro-economic matters, may affect fragile investor and depositor confidence
- banks in the Eurozone are required to meet higher capital requirements by June 2012
- actions by central banks (including the European Central Bank) and supervisory authorities to support the banking sector may be uncertain.



4 Going concern

Going concern status

Continuing difficult economic conditions in certain areas of the world (see Sections 2 and 3) mean that the assumption that the business is a going concern may not be clear-cut in some cases and management may need to make careful judgements relating to going concern.

Management needs to ensure that it is reasonable for them 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 an entity's ability to continue as a going concern, those uncertainties must be disclosed in the financial statements.

FRC Guidance

The UK's Financial Reporting Council (FRC) has produced 'Going Concern and Liquidity Risk: Guidance for Directors of UK Companies 2009', which brings together all the guidance previously issued by that regulator in relation to going concern and continues to promote the awareness of the issues facing companies in the current environment.

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 undertake 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 preparing financial statements, management is required to include 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 is made on the date that management approves the financial statements. Management have three potential conclusions:

- there are no material uncertainties and therefore no significant doubt regarding the entity's ability to continue as a going concern. Disclosures sufficient to give a fair presentation are still required, meaning that management need to explain why it considers it appropriate to adopt the going concern basis, identify key risks and say how these have been addressed
- there are material uncertainties and therefore there is significant doubt 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 management reaches, the disclosures can be complex and difficult to compose. If going concern might be an issue for the company, management should allow extra time to consider this.

Part of being consistent

The going concern disclosures also need to be considered in the light of other information in the financial statements and any accompanying management commentary. Section 1 covers the importance of the financial statements and management commentary complementing and being consistent with each other as a whole, and the disclosures explaining why the entity is considered to be a going concern are an important part of that.

Management should consider whether there is information which suggests that there may be uncertainties over going concern, and ensure that this is addressed in the disclosures they give. This might include, for example, financial information such as impairment losses, cash outflows or disclosures showing significant debts due for repayment within a year, as well as narrative disclosures such as principal risks and uncertainties and financial risk management information. The effects of intercompany indebtedness and any concerns over the recoverability of intercompany balances should also not be overlooked. The going concern disclosures are an opportunity for management to explain why such matters do not affect the status of the entity as a going concern.

5 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 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 movements for available-for-sale financial assets and exchange differences on retranslation of foreign operations. Other comprehensive income does not include, for example, dividends or new share capital as these are transactions with owners in their capacity as such, rather than income or expenses. Hence, such items should be shown in the statement of changes in equity not 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 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.

Additional comparative statement of financial position

IAS 1 requires an additional comparative Statement of Financial Position, together with related notes, to be presented as at the beginning of the earliest comparative period whenever a new 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

Regulators continue to pay close attention to disclosures relating to judgements and estimates. Omissions may become apparent from management commentary, which comment on matters that are not then highlighted as areas of significant judgement or estimation in the financial statements.

Key judgements

Regulators have noted that IFRS is a principles based reporting framework which requires management judgement in its application. IAS 1 requires disclosure of the judgements that management has made in applying the 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). Regulators are likely to challenge companies that disclose no areas in which management has exercised judgements that have had a significant effect on amounts recognised in the financial statements.

The disclosure given about significant judgements should not simply list the areas of the financial statements affected, or repeat the accounting policies for the relevant areas, but should explain in what particular aspect management has exercised its judgement. Where application of a different judgement would have had a material effect on the matter reported, this point should be addressed in the disclosures.

Key assumptions and sources of estimation uncertainty

In addition to disclosing significant judgements, management is required to disclose key assumptions concerning the future and other key sources of estimation uncertainty 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). Though this disclosure is often combined with key judgements, it is a separate disclosure requirement and one that is often not well addressed.

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 or have been areas of significant debate with the auditor. 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?

6 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 of concern remain that:

- the accounting policy is not set out in sufficient detail
- it is not clear how the stage of completion is determined with reference to sales of services
- 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.

The revenue accounting policy must be clear as to how the principles of **IAS 18 'Revenue'** have been applied to the specific business and its significant revenue streams and demonstrate clearly the point at which revenue is recognised and the basis on which it is measured, particularly where the stage of completion has to be identified.

The primary issue when accounting for revenue is the determination of the point at which revenue may be recognised, ie when goods or services are delivered and when it is probable that future economic benefits will flow to the entity and can be measured reliably. Examples of areas where companies may be open to challenge regarding their revenue recognition policies include where:

- the accounting policy suggests that revenue might be recognised before the qualifying criteria have been satisfied, leading to an overstatement of income
- the accounting policy indicates that revenue is recognised on product delivery with no reference to customer acceptance or returns
- the company sells both goods and services and the policy is unclear as to how the various components have been accounted for.

Regulators have challenged companies that include detailed accounting policies which relate to apparently immaterial revenue streams. As noted in Section 16, unnecessary clutter such as immaterial or irrelevant accounting policies should be eliminated from a good set of financial statements.

Part of being consistent

In Section 1, we discussed the importance of consistency between the entity's management commentary and the financial statements, and narrative disclosures in general being consistent with the amounts in the financial statements. For example where a company refers to several income streams in its management commentary or segmental disclosures, it is essential that the accounting policies on revenue address each of the key revenue streams identified. Failure to do so is very likely to lead to questions from regulators.

When writing the accounting policies, management should ask themselves "Does our stated policy fit with management commentary about how we generate 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.

Multiple-element arrangements

The aim of IAS 18 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.

Changes in the business model

A company's business model will evolve over time. This may be through changes in strategy, organic growth, or as a result of acquisitions and disposals. Consequently, a company's revenue streams will change.

It is important that the revenue recognition policies are updated regularly to reflect these changes. A common issue is that changes in the business model are discussed in management commentary, in particular where these arise from acquisitions the company has made, but the changes to revenue streams that result are not reflected in the revenue recognition accounting policies.

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 recognised during the period, including 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.

7 The statement of cash flows

The importance of the statement of cash flows

All companies and groups reporting under IFRS are required to present a statement of cash flows. The purpose of this statement is to provide users of financial statements with the information they need to make an assessment of the ability of the reporting entity to generate cash and cash equivalents, as well as the needs of the entity to utilise that cash.

A further benefit of the statement of cash flows is that it enables comparisons to be made between different entities, because it is not impacted by factors such as the selection of different accounting policies for similar transactions or events.

The ability of an entity to generate cash has become even more important given the economic uncertainties existing in many areas of the world (see Section 2). It is possibly as a result of this that the statement of cash flows is coming under increased scrutiny. We outline below a number of areas where regulators have raised issues.

Cash and cash equivalents

As stated above, the purpose of the statement of cash flows is to provide information about how the reporting entity generates cash and cash equivalents. Cash includes both cash in hand and demand deposits. Cash equivalents are short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value. Therefore an investment normally qualifies as a cash equivalent only when it has a short maturity of, for example, three months or less from the date of acquisition.

Where the company's bank balance often moves between a positive balance and an overdraft position, this is evidence that the bank overdraft is an integral part of the management of cash in the business. Where this is the case, the bank overdraft should be included in cash and cash equivalents.

Longer term borrowings, such as bank loans, are not however part of cash and cash equivalents. Similarly, long term deposits are excluded from the definition. The inclusion of long term balances in cash and cash equivalents obscures the true short-term position. Regulators have challenged companies where such items are included in cash and cash equivalents.

Identification and classification of cash flows

It is important that all cash flow items are identified and appropriately included in the statement of cash flows. The consistency of management commentary and the financial statements as a whole should be considered in this regard. For example, if there is discussion of the disposals of assets or operations, or the issue or repurchase of shares in management commentary, then the relevant cash flows should be appropriately presented in the statement of cash flows.

Under **IAS 7 'Statement of Cash Flows'**, there are three types of cash flows, being cash flows from operating activities, investing activities and financing activities. Cash flows reported must be classified under these headings. Regulators have challenged companies which have not made this classification correctly. Each heading is explained below.

Operating activities

Operating activities are the main activities of the entity which generate revenue, as well as other activities which do not meet the definition of investing or financing activities. This category therefore includes items such as receipts from the sale of goods and services, and payments to suppliers.

The cash flows from operating activities may be presented using either the direct method, in which the major classes of cash receipts and cash payments are disclosed, or the indirect method. Under the indirect method, profit or loss is adjusted for non-cash items, movements in working capital and any income or expense items associated with investing or financing cash flows in order to reconcile to the total cash flows from operating activities.

Investing activities

Investing activities include the acquisition and disposal of long-term assets, such as property, plant and equipment, and the acquisition and disposal of investments not included in cash equivalents.

Investing cash flows are of importance to users of the financial statements because they represent the extent to which cash has been used to invest in resources which are intended to generate income in the future. Only expenditure which results in a recognised asset in the statement of financial position may be included in cash flows from investing activities. Accordingly, cash outflows in areas such as training or research (which might be viewed as investments in a broad sense) are not 'investing' under IAS 7 because such costs are required to be expensed under IFRS.

Financing activities

Financing activities result in changes to the size or composition of the contributed equity or borrowings of the entity. Examples of financing cash flows include the proceeds from the issue of shares and repayments of borrowings.

Cash flows arising from changes in ownership interests in subsidiaries which do not result in a loss of control are also classified as financing activities. This includes, for example, the purchase by the parent of a non-controlling interest in a subsidiary.

Foreign exchange differences

The treatment of foreign exchange differences in the statement of cash flows is a key area which causes problems in practice. Regulators have challenged companies where foreign exchange differences are reported in the reconciliation between profit or loss and the cash flows from operating activities, as this is an indicator that the reconciliation may not have been done correctly.

Where cash flows arise in a foreign currency, these should be recorded in the company's functional currency by translating each cash flow at the exchange rate on the date the cash flow occurred. An average rate for the period may be used where this approximates to the actual rates.

Where a group has a foreign subsidiary, the cash flows of that subsidiary should be translated into the group's presentation currency using the actual exchange rates at the dates the cash flows occurred. Again, an average rate may be used where this approximates to the actual rates.

Unrealised gains and losses may arise from changes in exchange rates. Such gains and losses are not cash flows. However, the effect of changes in exchange rates on cash and cash equivalents denominated in a foreign currency does need to be reported in the statement of cash flows in order to reconcile the opening and closing balances of cash and cash equivalents. This amount is presented separately from the cash flows from operating, investing and financing activities, and is typically shown at the foot of the statement of cash flows.

8 Business combinations

IFRS 3 Revised

The revised **IFRS 3 'Business Combinations'** was issued in 2008 and became effective for business combinations occurring in annual periods beginning on or after 1 July 2009. The areas of IFRS 3 which cause practical problems in application of the requirements or which are often overlooked are now becoming apparent. Some of these key areas are highlighted here.

Identifying a business

IFRS 3 defines a business as "an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants". Although the most common application of IFRS 3 is to the situation where one entity acquires another, the definition makes it clear that a business need not be an entity, – it can be a collection of assets and activities. In addition, it follows from the definition that the collection of assets and activities does not have to be providing returns right now, but must have the ability to do so in the future.

Consequently, difficulties can arise in determining whether a collection of assets is combined with activities such that it constitutes a business. Regulators have challenged companies where it appears that a transaction had been treated as a purchase of a group of assets when in fact it should have been treated as a business combination. An example of an indicator that a group of assets is a business is that employees are transferred with the acquired assets. Alternatively, it may be the types of assets acquired that give rise to questions, for example, assets arising from research and development.

Identifying the acquirer

In all business combinations in the scope of IFRS 3, one of the combining entities is required to be identified as the acquirer. The acquirer is the entity that obtains control of the acquiree. The acquirer is usually the entity that transfers cash or other assets or incurs liabilities, or that issues equity instruments to effect the business combination. However, in some business combinations, the issuing entity (the legal parent) is the acquiree for accounting purposes. Such business combinations are known as reverse acquisitions. Regulators have approached companies where there was a question over whether the acquirer had been properly identified under IFRS 3 and therefore whether the business combination was a reverse acquisition.

Relevant factors in determining which entity is the acquirer include:

- the relative voting rights in the combined entity after the business combination
- the existence of a large minority voting interest in the combined entity if no other owner or organised group of owners has a significant voting interest
- the composition of the governing body of the combined entity
- the composition of the senior management of the combined entity
- the terms of exchange of equity interests.

Accounting for a reverse acquisition

In a reverse acquisition, the accounting acquirer usually issues no consideration for the acquiree. Instead the accounting acquiree issues its equity shares to the owners of the accounting acquirer. However, in order to account for the business combination under IFRS 3, the consideration transferred needs to be determined based on an equivalent amount the accounting acquirer would have paid to effect the same combination.

Consolidated financial statements issued following a reverse acquisition will be in the name of the legal parent (the accounting acquiree) but are presented as a continuation of the legal subsidiary (the accounting acquirer). The exception to this is that the financial statements, including the comparatives, reflect the capital structure (that is, the legal share capital and share premium) of the legal parent. Appendix B to IFRS 3 sets out how to calculate the consideration as well as how the consolidated financial statements are to be presented following a reverse acquisition.

Intangible assets acquired

IFRS 3 requires the identifiable assets and liabilities acquired to be recognised at their acquisition date fair values. This includes identifiable intangible assets of the acquiree, whether or not these were recognised in the accounts of the acquiree. IFRS 3 is also clear that all identifiable intangible assets acquired in a business combination should be capable of reliable measurement.

Where a business combination is discussed in a company's management commentary, 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. Regulators have noted that it is often apparent that not all acquired intangibles have been recognised because of inconsistency between the management commentary and the disclosures.

Where the acquirer is not intending to use an intangible asset acquired in a business combination, for example, where the acquiree has a brand name which is to be discontinued, the acquirer is still required to recognise the asset at fair value. The decision not to use the asset may result in an impairment charge being recognised in post-acquisition profit or loss.

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 depending on, for example, the level of future profits of the acquiree. Any contingent consideration in a business combination is included, at fair value, in the consideration transferred at the acquisition date.

Where contingent consideration gives rise to a financial asset or liability within the scope of **IAS 39 'Financial Instruments: Recognition and Measurement'**, changes in fair value after the acquisition are recognised in profit or loss or in other comprehensive income in accordance with IAS 39. Where contingent consideration meets the definition of equity under **IAS 32 'Financial Instruments: Presentation'**, there is no subsequent remeasurement. It is important that there is adequate disclosure in the accounting policies or in the notes to explain how contingent consideration has been accounted for. In particular, regulators have challenged companies that recognised contingent consideration liabilities but had not explained how those liabilities were measured.

Requirement for future services

Where contingent consideration contains a requirement to provide future services, for example, in the case of former owners of the acquiree who become employees after the acquisition, then that consideration is not part of the consideration transferred to obtain control of the business. Instead it relates to the services to be received and should be recognised as a post-acquisition expense, rather than increasing goodwill.

9 Impairment testing and disclosure

Impairment testing and disclosure

Impairment testing under **IAS 36 'Impairment of Assets'** continues to be an important issue for many businesses, whilst the disclosures about 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 and the disclosure requirements are extensive.

The impairment testing process

Identification of cash-generating units

If there are indicators that an individual asset is impaired, it is tested for impairment. More commonly, cash-generating units (CGUs) are tested. A 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 extensive 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, before any aggregation of operating segments into reportable segments. The allocation of assets to CGUs gives the carrying value which will be compared to recoverable amount to determine the amount of any 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.

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.

Disclosure requirements of IAS 36

IAS 36 requires extensive disclosure of information relating to different stages of the impairment process to be given for each CGU to which significant goodwill is allocated or which has suffered an impairment. In addition, there are likely to be significant judgements or key sources of estimation uncertainty arising from the impairment testing, which should be disclosed under **IAS 1 'Presentation of Financial Statements'** (see Section 5). Regulators have challenged companies where no significant judgements were identified in the impairment testing process.

Discount rates and growth rates

The discount rates and growth rates used in calculating the recoverable amount of each CGU should be disclosed. The rates should be specific to the risks of each CGU. 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.

Regulators have been known to challenge companies where the discount rates applied to different CGUs is unclear, or where the same rate is applied to a number of CGUs with disparate activities.

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 estimated (using approved budgets or forecasts) is required to be disclosed, with an explanation given where this exceeds five years. Although IAS 36 only requires an explanation to be given where the period covered by approved budgets or forecasts exceeds five years, this does not mean that a five year period must be used. If, for example, management only prepare approved budgets for a two year period, those should be used for the impairment test, with the cash flows then extrapolated beyond that period. IAS 36 does not require management to prepare a five year forecast for the purpose of the impairment test.

Assumptions should be disclosed for both the period covered by approved budgets and beyond this period. The growth rate used to extrapolate beyond the period covered by approved budgets is also required to be stated, and justification will be needed where this is higher than the long-term average growth rate for the products, industry or country in which the CGU operates. High growth rates will be difficult to justify in the long term, because, when high growth is available in a particular market, competitors are likely to enter that market and therefore restrict the growth available to companies already in that market.

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.

Events or circumstances leading to an impairment

Regulators have highlighted IAS 36's requirement to disclose the events or circumstances leading to a material impairment loss or the reversal of an impairment loss. Discussion of such events in management commentary that precedes the financial statements will not meet the requirements of IAS 36 unless a cross-reference is given from the impairment disclosures within the audited financial statements. Where the disclosure is given separately, it is important to ensure consistency with management commentary.

10 Asset disposals and discontinued operations

Disposals of assets or operations

Difficult trading conditions mean that many companies are seeking to restructure their businesses. In some cases, this leads to disposals of assets or operations, in which case **IFRS 5 'Non-current Assets Held for Sale and Discontinued Operations'** will be relevant.

Where a subsidiary is disposed of, the requirements of **IAS 27 'Consolidated and Separate Financial Statements'** will also apply to the calculation of the gain or loss on disposal in the consolidated accounts. However, the discussion here focuses on the requirements of IFRS 5.

Classification as held for sale

A non-current asset or disposal group should be classified as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use. This classification is appropriate under IFRS 5 only where the sale is highly probable and the asset, or disposal group, is available for sale immediately in its present condition, subject only to terms that are customary for sales of such assets.

Consequently, an intention to sell will not be sufficient to meet the held-for-sale classification under IFRS 5. The following criteria must be met:

- management are committed to a plan to sell the asset or disposal group
- an active programme to locate a buyer and complete the plan to sell is in place
- the asset, or disposal group, is being actively marketed for sale at a reasonable price in relation to its fair value
- the sale is expected to be complete within one year from the date of classification as held for sale.

In some cases, events beyond the control of the company may extend the time taken to complete the sale beyond one year. Where this happens but there is sufficient evidence that management remain committed to their plan to sell the asset or disposal group, classification as held for sale may still be appropriate.

What is a disposal group?

IFRS 5 defines a disposal group as a group of assets to be disposed of in a single transaction, together with liabilities directly associated with those assets which will be transferred in the same transaction. Where the disposal group is either a cash-generating unit (CGU) to which goodwill has been allocated (see Section 9), or an operation which is part of such a CGU, then the disposal group will include the associated goodwill.

Measurement of non-current assets held for sale

Non-current assets within the scope of the measurement requirements of IFRS 5 are required to be measured at the lower of their carrying amount and fair value less costs to sell. Where fair value less costs to sell is lower, this will result in an impairment charge being recognised when the asset or disposal group is classified initially as held for sale. If fair value less costs to sell subsequently increases, this is recognised to the extent that it reverses a previous impairment loss.

Exceptions to the measurement provisions of IFRS 5

Certain assets are specifically excluded from the measurement requirements of IFRS 5. As a result, when these assets are classified as held for sale, they continue to be measured in accordance with the relevant standard. Examples include investment property carried at fair value under **IAS 40 'Investment Property'** and deferred tax assets in the scope of **IAS 12 'Income Taxes'**.

Presentation and disclosure

Presentation of non-current assets held for sale

In the statement of financial position, non-current assets held for sale, or the assets of a disposal group classified as held for sale, are required to be presented separately from other assets. This requirement is typically met by giving a sub-total for current assets followed by a line item 'Non-current assets classified as held for sale' and then a further total. Similarly, the liabilities of a disposal group should be presented separately from other liabilities. The assets and liabilities of a disposal group must not be offset.

Disclosure of non-current assets held for sale

IFRS 5 also requires information to be given including a description of non-current assets or disposal groups which have either been classified as held for sale or sold, together with a description of the facts and circumstances of the sale or expected sale and the expected manner and timing of that sale.

The gain or loss recognised on measurement at fair value less costs to sell is also required to be disclosed, as is the reportable segment in which the non-current asset, or disposal group, is presented under **IFRS 8 'Operating Segments'**.

Discontinued operations

A non-current asset or a disposal group that meets the criteria to be classified as held for sale under IFRS 5 may also be a discontinued operation under IFRS 5, although this is not necessarily the case.

A discontinued operation is a component of an entity which is either classified as held for sale or has been disposed and meets one of the following three conditions:

- it represents a separate major line of business or geographical area of operations
- it is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations
- it is a subsidiary acquired exclusively with a view to resale

A component of an entity has both operations and cash flows and can be clearly distinguished from the rest of the entity. It will have been either a CGU or a group of CGUs while being held for use.

Presentation of discontinued operations

The statement of comprehensive income (or separate income statement, if presented) is required to show a single amount comprising the total of the post-tax profit or loss of discontinued operations and the post-tax gain or loss on remeasurement to fair value less costs to sell of the assets or disposal groups which make up the discontinued operation.

Further analysis of this single amount is required, either in the statement of comprehensive income or in the notes. This analysis is required to show:

- the revenue, expenses and pre-tax profit or loss of discontinued operations
- the gain or loss recognised on the measurement to fair value less costs to sell or on disposal of the assets or disposal groups which make up the discontinued operation
- the related income tax expense associated with each of the above.

The net cash flows attributable to the operating, investing and financing activities of discontinued operations should also be disclosed.

11 Share-based payment arrangements

Share-based payment arrangements

Share-based payments such as share option schemes are an increasingly popular way for companies to incentivise and remunerate their employees. Management may look for innovative ways to structure such arrangements in order for these to be tax-efficient. The accounting requirements for such awards are found in **IFRS 2 'Share-based Payment'**. This section discusses some key areas which cause problems in practice.

The impact of a settlement choice

IFRS 2 defines both equity-settled and cash-settled share-based payment arrangements. However, some arrangements provide either the entity or the counterparty with the choice of how the award will be settled. Where this is the case, the accounting treatment must be considered carefully.

The counterparty has the choice of settlement

Where the counterparty (eg the employee) can choose whether they receive cash or equity instruments under a share-based payment arrangement, the entity granting the award has granted a compound financial instrument, which includes a debt component and an equity component.

For transactions with employees, the fair value of the compound financial instrument is determined at the grant date by first measuring the fair value of the debt component and then the fair value of the equity component. The fair value of the equity component will take into account the fact that the employee must forfeit the right to receive cash in order to receive the equity instrument. The sum of these is the fair value of the compound financial instrument. Where the arrangement is structured such that the fair value of the two settlement alternatives is the same, the fair value of the equity component will be nil.

The entity has the choice of settlement

Where the entity has the choice as to how the arrangement is settled, management must consider whether there is a present obligation to settle in cash. This will be the case if the option to settle in equity has no commercial substance, or the entity has a past practice or stated policy of settling in cash, or the entity generally settles in cash when requested to do so by the counterparty. Where the entity has a present obligation to settle in cash, the arrangement is accounted for as a cash-settled share-based payment. Where there is no such obligation, the arrangement is accounted for as an equity-settled share-based payment.

Conditions associated with a share-based payment

A share-based payment may have a number of conditions which need to be met in order for the employees to be entitled to receive the award. It is important that all such conditions are identified and then classified appropriately under IFRS 2, as the treatment of the award differs according to the type of condition.

Non-vesting conditions are conditions which do not determine whether the entity receives the services that entitle the counterparty to receive the award. This means that if a non-vesting condition is not met, it does not impact on the services the entity receives.

An example is the requirement for an employee to save in a Save As You Earn (SAYE) scheme. In a typical SAYE scheme, employees are given the opportunity to subscribe for shares (often at a discount to the market price) if they save a regular amount. The savings are usually made by a deduction from the employees' wages and are applied to cover the exercise price of the options upon exercise. Employees can stop contributing

and obtain a refund of their contributions at any time, but forfeit their entitlement to exercise their options if they do so. An employee's decision to stop saving does not change the fact that he or she continues to provide the company with services however. Under IFRS 2 an employee's decision to stop saving is treated as a cancellation of the share-based payment (see below).

Vesting conditions are the conditions which determine whether the entity receives the services that entitle the counterparty to receive the award. They can be service conditions, which require only a specified period of service to be completed, or performance conditions, which require certain performance targets to be met in addition to a period of service. Performance conditions are market conditions if they are related to the entity's share price.

Impact on selecting a valuation model

Both non-vesting and market performance conditions are required to be taken into account in determining the grant date fair value of a share-based payment. As a result, the types of valuation model that can be used are limited where such conditions exist. For example, the Black-Scholes formula is not suitable where there are market conditions.

Modifications to share-based payments

Companies that set up share-based payment schemes some years ago may find that they no longer provide the incentive to employees that was originally intended, for example because falling share prices have resulted in share options being out of the money. In this situation, management may decide to modify the terms of the arrangement, and this will have accounting consequences.

Where the terms of a share-based payment are modified, the incremental fair value at the date of the modification must be calculated. This is the excess of the fair value of the modified award over the fair value of the original award, both calculated at the date of the modification. If, for example, a share option scheme is modified and the only change is to reduce the exercise price of the options, this means that there must be an incremental fair value at the date of the modification.

The incremental fair value is then spread over the remainder of the vesting period in addition to the share-based payment charge based on the grant date fair value of the original award. If the incremental fair value is negative, there is no change to the accounting and the charge continues to be based on the grant date fair value of the original award.

Cancellations and replacement awards

Where a share-based payment award is cancelled by either the entity or the counterparty, the company is required to recognise immediately the amount that otherwise would have been recognised over the remainder of the vesting period. If, however, the company grants a new award and, on the date that it is granted, identifies it as a replacement for the cancelled award, then this is accounted for as a modification.

Group situations

It is common for one group entity, typically the parent company, to grant share-based payment awards to the employees of another group entity, typically a subsidiary. Where this occurs, the accounting treatment needs to be considered in the individual accounts of each entity involved, as well as in the consolidated accounts.

The entity receiving the services accounts for the scheme as equity-settled if it is settled in its own equity instruments or if another entity will settle the obligation (whether in cash or shares). Otherwise it accounts for the award as a cash-settled share-based payment.

The entity settling the award but not receiving services recognises the award as an equity-settled share-based payment only if it is settled in that entity's own equity instruments. Otherwise the award is accounted for as a cash-settled share-based payment. The entity settling the award also needs to consider where the debit entry goes if it is not receiving the services under the arrangement. In the typical case of a parent company which has granted awards to employees of a subsidiary, the debit entry is usually made to cost of investment in subsidiary.

12 Debt or equity? Identifying financial liabilities

Introduction

Applying the fixed-for fixed test in **IAS 32 'Financial Instrument: Presentation'** to determine whether financial instruments such as convertible debt, warrants or preference shares are debt or equity has been a recurring theme for some years now. In addition, difficulties arise in determining whether payments to be made on the occurrence of uncertain future events give rise to financial liabilities under IAS 32. As companies look to raise finance, new types of capital instrument continue to emerge. Although IAS 32 has been in place for a number of years it remains topical as companies consider how it applies to these new instruments.

What is the fixed-for-fixed test?

The definition of a financial liability in IAS 32.11 has two elements. The first covers the situation where an entity has a contractual obligation to deliver cash or to exchange financial instruments in a way which is potentially unfavourable. The second element relates to contracts which may be settled in an entity's own equity instruments. Some contracts which may be settled in an entity's own equity instruments are financial liabilities (debt), some are equity and some have both debt and equity components. This classification is dependent on the fixed-for-fixed test. The fixed-for-fixed test may seem straightforward at first glance, but experience shows that this is rarely the case.

Essentially, a contract is classified as equity if it will, or may, be settled by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. Where this is the case, the fixed-for-fixed test is passed. Otherwise, the instrument fails the test and the entity has a financial liability. An important point is that a contract is not necessarily itself an equity item simply because it is paid or settled using the entity's own shares.

Convertible bond example

What if a company has issued a convertible bond which the holder can convert into ordinary shares of the entity? The fixed-for-fixed test determines how the conversion option is accounted for.

If the conversion option passes the fixed-for-fixed test, then it is an equity component. However, there is also a liability component, being the obligation to pay cash, and therefore the bond is a compound financial instrument. The fair value of the liability component on inception would be equal to the cash outflows discounted by a market rate for a straight (non-convertible) bond. The equity component is simply the residual amount after deducting the debt component from the fair value of the instrument as a whole. The equity component would not then be remeasured subsequently, so changes in the fair value of the conversion right would not normally affect profits.

If the conversion option fails the fixed-for-fixed test, the company must account for the entire instrument as a liability. That liability is effectively a host debt contract with an embedded derivative. Under **IAS 39 'Financial Instruments: Recognition and Measurement'**, in most cases, the company would be required to separate the embedded derivative from the host debt contract and carry this embedded derivative at fair value through profit or loss. To value this conversion option would require the use of valuation experts, which can be costly and time consuming. The changes in value of the embedded derivative, which reflect the fair value movements of the conversion right, would affect profit or loss.

Variation clauses

Instruments such as convertible bonds, warrants or preference shares which can be converted to ordinary shares often include variation clauses which alter the conversion ratio. These are often described as anti-dilution clauses, and may be included in the contract with the intention of preserving the rights of the holders of the convertible instruments relative to other equity holders.

Where such variation clauses simply preserve the rights of all equity holders relative to each other, they will not cause the fixed-for-fixed test to fail if the original conversion terms before the variation clause passed the fixed-for-fixed test. However, clauses described as anti-dilution often go beyond this, in which case they cause the fixed-for-fixed test to fail, and as a result the conversion option must be treated as a financial liability.

Foreign currency

Another practical problem arises where the conversion price or option exercise price is denominated in a currency other than the functional currency of the issuer. Where this is the case, the conversion terms might be such that a fixed amount in a foreign currency converts to a fixed number of shares. However, the fixed-for-fixed test is failed because a fixed amount of foreign currency is not a fixed amount of cash in the issuing entity's functional currency.

Contracts to purchase own shares

Special rules apply to contracts that might result in the issuing entity having to purchase its own shares for cash (eg written put options). This type of contract creates a liability, even when the 'fixed-for fixed' test is met. The liability is recognised as the present value of the exercise purchase price, and the debit is recorded in equity (IAS 32.23). Interest is accrued on this liability as the discount unwinds over time.

If the contract is an option and the option lapses unexercised, the liability is transferred to equity.

Contingent settlement provisions

Contingent settlement provisions relate to contracts where the issuer is required to make a payment based on uncertain future events. In broad terms, if a payment is required based on an uncertain future event that is controlled neither by the issuer nor the holder of the instrument, then that contingent payment represents a financial liability.

There are two exceptions to this. The first is where the contingent event is a liquidation, provided that liquidation itself is neither pre-planned nor at the discretion of one of the financial instrument holders. The second exception is where the obligation is not genuine. However, this is defined very narrowly, such that 'not genuine' means the event that would give rise to the contingent payment is extremely rare, highly abnormal and very unlikely to occur.

Two types of contingent settlement provision that are particularly common and that cause problems in applying the requirements of IAS 32 are obligations based on a percentage of profit and obligations arising from a change of control.

Payments of a percentage of profits

A common issue arises from requirements to pay a percentage of profits as dividends on shares. These contingent dividends are a financial liability because future revenue and profits are not in the control of the issuer.

Payments contingent on change in control

Where there is an obligation to pay cash on a change of control, such as to redeem preference shares, the definition of a financial liability will normally be met. This is because management cannot prevent shareholders from selling their shares.

However, in certain limited circumstances, such as when change in control can only be sanctioned in a general meeting via normal simple majority voting, such that the shareholders are essentially part of management when making the decision, it may be possible to argue that a payment to be made on change of control is not a financial liability. This is likely to be a significant judgement which should be disclosed in the financial statements.

13 Financial instruments disclosures

Financial instruments disclosures

IFRS 7 'Financial Instruments: Disclosures' sets out extensive disclosure requirements in relation to financial instruments. Although IFRS 7 has been effective since 2007, it has been amended several times since. Financial instrument disclosures are often highly significant to users of the financial statements. Given the continued economic uncertainties, they have an even greater significance at present. Some of the key disclosures are covered here.

Categories of financial instrument

One of the key disclosures in IFRS 7 is that entities are required to disclose the carrying amounts of their financial assets and liabilities analysed by the categories defined in **IAS 39 'Financial Instruments: Recognition and Measurement'**. These categories are:

- financial assets at fair value through profit or loss
- held-to-maturity investments
- loans and receivables
- available-for-sale financial assets
- financial liabilities at fair value through profit or loss
- financial liabilities measured at amortised cost.

Impairment of financial assets

IFRS 7 requires disclosure of the impairment loss recognised on each class of financial assets. In addition, when financial assets are impaired by credit losses and the impairment is recorded in a separate account rather than directly reducing the carrying amount of the assets, a reconciliation of movements in that allowance account should be presented for each class of financial assets. These requirements are among the most common disclosure requirements raised with companies by regulators.

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 reporting 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 Statement of Financial Position, which will either be fair values or, more commonly, amortised cost.

IFRS 7 requires qualitative disclosures to be given about the risks arising from financial instruments. It is important that the liquidity risk disclosures are tailored to the entity's circumstances, for example, an explanation of the future obligations should be given, together with an explanation of funding facilities available. The liquidity risk disclosures interact with the going concern disclosures, discussed in Section 4.

Sensitivity analysis

IFRS 7.40 requires that a 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 of a reasonably possible change in the underlying index. This disclosure requires comparatives. It is important that the methods and assumptions used in performing the sensitivity analysis are also disclosed.

The fair value hierarchy

IFRS 7 requires entities to classify financial assets and financial liabilities carried at fair value into a hierarchy based on the inputs into the measurement of their 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 where the inputs to the fair value measurement are not based on observable market data.

Hedge accounting disclosures

IFRS 7 includes specific disclosure requirements in relation to hedge accounting. Entities that apply hedge accounting are required to give a description of each type of hedge, the nature of the risks being hedged and a description of each financial instrument designated as a hedging instrument. These disclosures will help users of the financial statements to understand the risks the entity is exposed to and how they are managed.

In addition, there are a number of specific disclosures for cash flow hedges. Entities are required to disclose the period in which the cash flows are expected to occur and when those cash flows are expected to affect profit or loss. Any amounts reclassified from equity to profit or loss in the period are also required to be disclosed. These requirements are among the most common disclosure requirements raised with companies by regulators.

14 Capital management disclosures

Introduction

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). Regulators have raised concerns over inadequate compliance with these requirements, and we expect them to continue to focus on this area in the future.

Meaningful disclosure regarding capital management is particularly important in the difficult economic conditions which are being experienced in many countries. Many companies may have had 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.

The key requirements

IAS 1 requires both qualitative and quantitative disclosures about the management of capital, with the aim of enabling users of the financial statements to understand and evaluate an entity's objectives, policies and processes for managing capital.

In order to meet this aim, the disclosure given should include a description of what the entity manages as capital as well as summary quantitative data about what the entity manages as capital. Any changes in what is managed as capital also need to be explained.

Where there are externally imposed capital requirements, the nature of those requirements should be explained, together with information about how they are incorporated into the management of capital. Where applicable, entities also should state whether they have complied with externally imposed capital requirements during the period and, if not, the consequences of non-compliance.

ASB report

In response to regulator concern, the UK Accounting Standards Board (ASB) carried out a targeted review of capital management disclosures, the findings of which were published in December 2010. Although the report focuses on UK companies, its findings may be of interest to companies outside the UK. The key points raised in their report are discussed below.

Stakeholder interest in disclosures

The ASB found that, for all companies, investors and other stakeholders want to be able to understand what the company views as capital and its strategy for management of that capital, and do not believe that this is just a matter for banks and insurers subject to prudential regulation.

Management of different companies may approach capital management in very different ways. Similarly, investors will have different interests with regard to the management of capital. Some focus on historical invested capital, others on accounting capital and others on market capitalisation. Some investors consider capital in purely equity capital terms, while others include longer term debt.

While investors have a keen interest in capital, the ASB found that they do not currently make use of the disclosures given. The disclosures often do not meet the needs of investors because they are not given in an informative way and do not allow comparability between companies.

Issued identified with disclosures

The ASB found that only a minority of companies whose capital management disclosures they reviewed provided an enlightened analysis that explained their financial capital resources and how it related to their strategy. The majority of companies omitted disclosures or provided largely boilerplate information about financial capital, such that the disclosures did not convey meaningfully how those companies assess capital or how they manage it over the medium to long term.

What do good capital disclosures look like?

The ASB report also highlights examples of good practice in several areas, as discussed below.

Objectives and policies for the management of capital

The more informative disclosures about an entity's objectives and policies for the management of capital included the process for capital management, how often policies were revisited and how performance was assessed, together with discussion of objectives such as:

- maintaining an investment grade credit rating
- managing gearing to balance higher leverage with the advantages of a strong credit profile
- having enough capital to sustain future product development
- maintaining an optimal capital structure to balance financial flexibility and cost of capital
- reducing the cost of capital consistent with the entity's risk appetite.

Quantitative disclosures

Good examples of the quantitative disclosures about capital required by IAS 1 provided an analysis of capital linked to the amounts reported in the Statement of Financial Position, including a list of the various types of capital managed.

15 Hedge accounting

Introduction

Hedge accounting under **IAS 39 'Financial Instruments: Recognition and Measurement'** is purely optional but is permitted only where stringent conditions are met.

The objective of hedge accounting is to ensure that the gain or loss on the hedging instrument is recognised in profit or loss in the same period when the item being hedged affects profit or loss.

Hedge accounting departs from IAS 39's default principles in order to do this. This section highlights the conditions which need to be met in order to use hedge accounting, and sets out when hedge accounting must be discontinued.

Conditions applying to use of hedge accounting

Specific rules limit what can be considered as a hedging instrument, and what can be considered as a hedged item.

In summary, a hedging instrument can be a derivative financial instrument or, for hedges of foreign exchange risk only, a non-derivative financial instrument. Broadly speaking, the hedged item must be an identified hedged item or group of items that could affect profit or loss.

Furthermore, in order to be able to use hedge accounting, all of the following conditions must be met:

- at the inception of the hedge there is formal designation and documentation of the hedging relationship and the entity's risk management objective and strategy for undertaking the hedge
- the hedge is expected to be highly effective
- for cash flow hedges, a forecast transaction that is the subject of the hedge must be highly probable and must present an exposure to variations in cash flows that could ultimately affect profit or loss.
- the effectiveness of the hedge can be reliably measured
- the hedge is assessed on an ongoing basis and determined actually to have been highly effective.

If one of these criteria is no longer met, hedge accounting must be discontinued.

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.

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.

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.

16 The cutting clutter challenge

Clutter in financial statements

The disclosures required in IFRS continue to increase. In addition, public authorities in many jurisdictions have added reporting requirements in areas such as risk, governance, remuneration and sustainability. Unsurprisingly, recent years have seen a substantial increase in the average length of companies' financial statements in many parts of the world. Against this background, many companies, users and other stakeholders have been asking whether we are reaching 'information overload' – the point where the sheer volume of information starts to detract from its practical usefulness.

Standard-setters and regulators are mindful of this concern. Several bodies have launched consultations and studies aimed at finding a way to tackle clutter and thereby focus on the information that matters. Examples inlcude:

- the IASB, in its Agenda Consultation, has asked about whether it should develop a disclosure framework. This could lead to a less prescriptive and more principle-based approach to disclosure over time
- EFRAG and the FASB are collaborating in order to develop new thinking on how to ensure disclosures are relevant
- the Institute of Chartered Accountants of Scotland and the New Zealand Institute of Chartered Accountants have undertaken a joint project, 'Losing the Excess Baggage', resulting in specific recommendations to reduce the volume of disclosure.

These and other initiatives may point the way to longer-term solutions. But in the meantime can companies do anything to reduce the length of their report while complying with all the required standards? The UK Accounting Standards Board (ASB) believes they can. In 2011 the ASB published 'Cutting Clutter – Combatting clutter in annual reports'. This followed a discussion paper 'Louder than Words: Principles and actions for making corporate reports less complex and more relevant' that was published by the UK's Financial Reporting Council (FRC) in 2009.

What is clutter?

The ASB report explains the term clutter as comprising two problems:

- immaterial disclosures that inhibit the ability to identify and understand relevant information, and
- explanatory information that remains unchanged from year to year.

Immaterial disclosures can often be found where detailed notes are given in support of line items in the accounts which are small. A specific example given in the ASB report is share-based payment. An example of explanatory information that often remains unchanged, or largely unchanged, from year to year is the accounting policies note.

The barriers to cutting clutter

The ASB report identifies behavioural issues as a key barrier to cutting clutter in financial statements. They are not referring only to the behaviour of preparers, but also regulators, standard setters, auditors and institutes. All of these parties may have a tendency to err on the side of caution, by including each and every disclosure requirement in the financial statements. However, because the barrier is behavioural, some change can be achieved to cut clutter without changing standards or guidance.

Actions to take

Both the FRC discussion paper and ASB report aim to provide guidance to preparers of financial statements. The FRC discussion paper provides four guiding principles for communication to be:

- focused
- open and honest
- clear and understandable
- interesting and engaging.

The ASB report provides disclosure aids for three areas of financial statements which often contain clutter, being governance disclosures, accounting policies and share-based payment disclosures.

Four actions that all companies can take are considered below.

Accounting policies

Accounting policies should be specific to the circumstances of the reporting entity. Management should review and assess the accounting policies given in the financial statements. Where accounting policies are not relevant to an entity's business, they are irrelevant and add clutter, and should be deleted.

Eliminate duplication

Information is often duplicated within financial statements, particularly where management commentary is given. This duplication of information creates clutter. Management should seek to minimise such duplication, and, for example, make use of cross references where appropriate.

Remove immaterial disclosure

IAS 1 'Presentation of Financial Statements' states clearly that a specific disclosure required by an IFRS need not be provided if the information is not material (IAS 1.31). Materiality is judgemental, and this is an area where there is a tendency to err on the side of caution, perhaps to avoid questions arising from regulators if the disclosure were not included. However, this is an area where management can cut clutter in financial statements by giving careful consideration to whether or not disclosures are material.

Clarity of expression

One aim of cutting clutter is to increase the clarity of the financial statements for users. An element of this is looking at the clarity of expression and the language used in the financial statements, in order to assess whether complicated information is communicated in a clear way that users will be able to understand.

The future of the debate

The ASB report makes three calls for action considered necessary to remove some of the existing barriers. They are:

- continue to encourage debate about what materiality means from a disclosure perspective
- investigate the possibility and potential benefits of separating explanatory information, either within or outside the financial statements
- engage with other stakeholders regarding their information requests.

Both the FRC and ASB have called for the debate on cutting clutter to continue, but recognise that change will only happen if all those involved in corporate reporting make a concerted effort.

17 Detail counts…

Related party disclosures

Issues over related party disclosures and compliance with **IAS 24 'Related Party Disclosures'** continue to arise and draw comment from regulators. Whilst these issues do not affect reported profits, related party disclosures are often significant to readers of the financial statements, and thus should not be overlooked.

Revision of IAS 24 Related Party Disclosures

A revised version of IAS 24 was issued in November 2009 and is effective for periods beginning on or after 1 January 2011. The two main changes brought in by the revised standard are:

- the introduction of an exemption from IAS 24's disclosures for transactions with: (a) a government that has control, joint control or significant influence over the reporting entity; and (b) 'government-related entities' (entities controlled, jointly controlled or significantly influenced by that same government)
- a change to the definition of related parties. The definition now explicitly includes as related parties of one another:
  - two joint ventures of the same third party
  - a joint venture and an associate of the same third party (but not two associates).

If a reporting entity applies this exemption, it is required to disclose the name of the government in concern and the nature of its relationship with the reporting entity. It is also required to disclose information on the nature and amount of each individually significant transaction with the government or government-related entity. For other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent is required to be disclosed.

Key management personnel compensation

IAS 24.17 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 management personnel may include persons such as leaders of key divisions within the group as well as the more obvious boardroom representatives of the parent company.

The IAS 24 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 remuneration disclosures for management under local legislation.

The impact of tax rate changes

Where there have been changes to the rate of tax, the accounting for current tax will need to be considered, in particular where a company's accounting period straddles the date at which a new tax rate becomes effective. The effective tax rate for such a period will need to be calculated by weighting the tax rates applicable before and after the change.

The main impact, however, is in the accounting for deferred tax. **IAS 12 'Income Taxes'** requires deferred tax assets and liabilities to be calculated using the tax rates expected to apply to the period that the asset is realised or the liability settled, based on tax rates that have been enacted or substantively enacted at the reporting period date. Companies will therefore need to estimate the period in which deferred tax assets are expected to be realised and liabilities settled and apply the tax rates for the relevant periods based on the rates that have been enacted by the end of the reporting period.

Onerous operating leases

IAS 37 'Provisions, Contingent Liabilities and Contingent Assets' defines an onerous contract as a contract in which the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it. The continuing difficult economic conditions being experienced in many areas of the world increase the potential for operating leases to become onerous, such that a provision is required to be recognised in the financial statements in accordance with IAS 37.

Situations that increase the likelihood that a lease is onerous include the following:

- the leased asset is abandoned, partly abandoned or under-utilised
- the leased asset is used in a loss-making operation
- the rentals payable under the lease are above current market rates

The presence of one or more of these factors increases the likelihood that a lease is onerous, but does not necessarily mean that this is the case. In order to determine whether a lease is an onerous contract and a provision is needed, management will need to compare the unavoidable costs of a lease and expected economic benefits to be received on a case-by-case basis.

18 What's on the way for 2012?

IFRS changes for 2012

As for 2011, there are no major new IFRSs with a mandatory effective date in 2012. Therefore many companies will have the advantage of relative stability when preparing their financial statements. However, there are some smaller changes which take effect and have the potential to impact on 2012 financial statements in certain situations. These are outlined below.

Amendments to IFRS 7

IFRS 7 'Financial Instruments: Disclosure' has been amended with effect for periods beginning on or after 1 July 2011. For companies with December year-ends, this means that the first year to be impacted will be the year ending 31 December 2012.

The amendments to IFRS 7 will mainly impact financial institutions. As a result of the amendments, additional disclosures are required where financial assets are derecognised but there is continuing involvement. The new disclosures are designed to provide information that enables users:

- to understand the relationship between transferred financial assets that are not derecognised in their entirety and the associated liabilities; and
- to evaluate the nature of, and risks associated with, any continuing involvement of the reporting entity in financial assets that are derecognised in their entirety.

The approach to derecognition set out in **IAS 39 'Financial Instruments: Recognition and Measurement'** is not changed by the amendments.

Amendments to IAS 12

Amendments have been made to **IAS 12 'Income Taxes'** which are effective for periods beginning on or after 1 January 2012. However these amendments are limited in scope and will apply only to companies that have investment property measured at fair value under **IAS 40 'Investment Property'**. The amendments introduce a rebuttable presumption that in such circumstances, an investment property is recovered entirely through sale.

Guidance in **SIC 21 'Income Taxes – Recovery of Revalued Non-Depreciable Assets'** addressing similar issues involving non-depreciable assets measured using the revaluation model in **IAS 16 'Property, Plant and Equipment'** has also been incorporated into IAS 12 and SIC 21 is withdrawn.

Presentation of other comprehensive income

The IASB has issued an amendment to IAS 1 entitled **'Presentation of Items of Other Comprehensive Income'**. The amendment is effective for periods beginning on or after 1 July 2012.

The amendment does not change which items are presented in other comprehensive income, but does change the structure of their presentation. The main change is a requirement for entities to group items presented in other comprehensive income into those that, in accordance with other IFRSs:

- will not be reclassified subsequently to profit or loss
- will be reclassified subsequently to profit or loss when specific conditions are met.

The IASB has backed away from its previous proposals to require a single statement of comprehensive income, so presentation in two consecutive statements, being an income statement and a statement of comprehensive income, will continue to be permitted.

19 What's on the way for 2013?

IFRS changes for 2013

In contrast to 2012, there are a number of new and amended standards with an effective date of 1 January 2013 which will impact IFRS preparers. These include new standards on consolidation, joint arrangements and fair value measurement, as well as amendments to the accounting for defined benefit pension schemes.

With the exception of fair value measurement, the main changes are applied retrospectively, giving a transition date of 1 January 2012 for companies with a 31 December period end. Although transitional reliefs may be available in certain circumstances, this means that these changes need to be thought about now.

Interests in other entities

In May 2011 the IASB issued a package of new standards covering the accounting for interests in other entities, as well as new disclosure requirements. The new standards are:

- **IFRS 10 'Consolidated Financial Statements'** which supersedes IAS 27 'Consolidated and Separate Financial Statements' and SIC 12 'Consolidation – Special Purpose Entities'
- **IFRS 11 'Joint Arrangements'** which supersedes IAS 31 'Interests in Joint Ventures'
- **IFRS 12 'Disclosure of Interests in Other Entities'**
- **IAS 27 (Revised) 'Separate Financial Statements'**, and
- **IAS 28 (Revised) 'Investments in Associates and Joint Ventures'**.

Companies with investments in other entities, in particular subsidiaries and joint ventures, will need to reassess the accounting treatment they apply. The key points of IFRSs 10, 11 and 12 are covered briefly below.

IFRS 10 Consolidated Financial Statements

IFRS 10 provides a revised framework to assess when one entity controls another, which will apply both to more conventional subsidiaries and to special purpose vehicles. In most cases, conclusions as to what should be consolidated are likely to be unchanged. However, 'borderline' consolidation decisions taken under IAS 27 will need to be reassessed and some will need to be revised.

Significant judgement will be needed in applying the definition of control in certain situations. For example, this will be the case where an entity holds potential voting rights over another entity. In addition, IFRS 10 is clear that control can exist where a minority of voting rights are held but the remaining voting rights are held by a large number of widely dispersed shareholders.

IFRS 11 Joint Arrangements

IFRS 11 defines two types of joint arrangement, being joint operations and joint ventures. This contrasts with the three classifications in IAS 31, which is replaced by IFRS 11. As a result, entities with interests in joint arrangements will need to assess the classification of the arrangement under IFRS 11.

In most cases, jointly controlled entities under IAS 31 will be joint ventures under IFRS 11. However, IFRS 11 does not allow proportionate consolidation for joint ventures. Instead, equity accounting under IAS 28 must be applied. This will lead to a significant change for many companies.

IFRS 12 Disclosure of Interests in Other Entities

IFRS 12 is designed to complement the other new standards. It sets out consistent disclosure requirements for subsidiaries, joint ventures and associates, as well as unconsolidated structured entities. The disclosure requirements are extensive and will result in significant amounts of new disclosures for some companies.

Structured entities were previously referred to in SIC 12 as special purpose entities. The disclosures required by IFRS 12 aim to provide transparency about the risks a company is exposed to through its interests in structured entities.

Fair value measurement

IFRS 13 'Fair Value Measurement' was also issued in May 2011. The new standard does not specify which items must be measured at fair value. However, where fair value measurement is required by another standard, IFRS 13 sets out how fair value should be measured and gives requirements for the disclosure of fair value information. The requirements of IFRS 13 are to be applied prospectively as of the beginning of the annual period in which it is initially applied.

IFRS 13 defines fair value as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. It clarifies that fair value is based on a transaction taking place in the principal market for the asset or liability or, in the absence of a principal market, the most advantageous market. The principal market is the market with the greatest volume and level of activity for the asset or liability.

The disclosure requirements of IFRS 13 will result in significant amounts of additional disclosure for some companies, for example where investment property is measured at fair value. IFRS 13 extends the use of the fair value disclosures required by **IFRS 7 'Financial Instruments: Disclosures'** to non-financial items measured at fair value, and also requires disclosures about the fair value of certain items not measured at fair value.

Accounting for pension schemes

IAS 19 'Employee Benefits' has been amended for periods beginning on or after 1 January 2013. This will mainly impact the accounting for defined benefit pension schemes.

The corridor approach for the recognition of actuarial gains and losses has been removed, as has the option to recognise actuarial gains and losses in profit or loss. The impact of this is that all actuarial gains and losses will be recognised in other comprehensive income in the period in which they arise.

In addition, the calculation of net interest cost has changed. There will no longer be separate calculations of the expected return on plan assets and the interest cost of funding the defined benefit obligation. Instead, a single rate is applied to the net of the defined benefit obligation and plan assets. This will impact on profit or loss, with the majority of companies seeing a reduction in profits as a result.

20 What's on the horizon?

IFRS continues to change

The IASB has a heavy work programme to revamp major areas of IFRS over the next few years, including revenue, leasing and financial instruments. An update on these projects is given below. Although the impact may seem some way off, these major changes will need to be considered well in advance.

Revenue

The IASB and the US standard setter, the FASB, have a joint project to develop a new standard on revenue recognition, which will replace **IAS 18 'Revenue'**, **IAS 11 'Construction Contracts'** and several IFRS Interpretations Committee interpretations for IFRS preparers. An Exposure Draft (ED) of a proposed standard **'Revenue from Contracts with Customers'** was issued in June 2010. Following the comment period, in which over 900 comment letters were sent, the IASB and FASB have made changes to the proposals. As a result a new ED was published in November 2011 with a comment period ending on 13 March 2012. The final standard could be issued in the second half of 2012 and the effective date proposed in the ED is annual periods beginning on or after 1 January 2015. Application is expected to be retrospective, with restatement of comparatives. This means that any existing contracts in place at the start of the comparative period will be affected.

As the title indicates, the contract is central to how revenue will be accounted for once the final new standard is in place. 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.

Many respondents to the proposals in the ED were concerned that revenue from the rendering of services would be recognised much later than is currently the case under IAS 18, with recognition at the end of the contract in many cases. This area has been reconsidered and the new ED clarifies that transfer of control of services to a customer may happen continuously when certain criteria are met.

Leases

In August 2010, the IASB and FASB issued their long-awaited joint ED **'Leases'**. When issued as an IFRS, this will replace the present standard, IAS 17. The new standard will cover both lessees and lessors. As for revenue, a large number of comment letters were received and the proposals for leases are going to be re-exposed, as significant changes have been proposed to the original ED. The new ED is expected in the second quarter of 2012 and the effective date of the new standard is expected to be years beginning on or after 1 January 2015.

For lessees, the existing operating lease versus finance lease distinction will be removed and replaced by a single model based on rights of use. All leases will be included in the Statement of Financial Position, as the lessee will recognise a right-of-use asset and a corresponding liability for the obligation to pay rentals. The IASB is proposing some transitional reliefs but many existing leases will nevertheless need to be restated.

For lessors, the 2010 ED proposed two approaches depending on the exposure of the lessor to the risks and benefits of the underlying asset. However, it appears likely that the proposals for lessors will change in the new ED.

IFRS 9 Financial Instruments

IFRS 9 'Financial Instruments' will replace **IAS 39 'Financial Instruments: Recognition and Measurement'**, and is currently being developed in stages by the IASB. The original intention was that IFRS 9 would be effective for periods beginning on or after 1 January 2013, however the IASB has now decided to delay implementation until periods beginning on or after 1 January 2015. Early application of the standard's requirements is permitted (subject to any constraints imposed by local jurisdiction).

Phase 1: Classification and measurement

The requirements for classification and measurement of financial assets and liabilities have been issued. IFRS 9 has only two categories for the classification of financial assets, compared to the four categories in IAS 39. For financial liabilities, most requirements from IAS 39 have been carried forward into IFRS 9, although some changes have been made to the fair value option for financial liabilities to address issues on own credit risk. Although this part of IFRS 9 had been considered final, the IASB have recently decided to re-open the project to address application issues, including specific concerns for insurance companies, and to explore opportunities to reduce differences with US GAAP.

Phase 2: Impairment methodology

Following the issue of the ED in 2009 and a supplementary document early in 2011, the IASB is currently re-deliberating the proposals on the impairment of financial assets. The broad theme is to replace IAS 39's current 'incurred loss' approach with an expected loss approach. The proposals to date have been criticised as very complex to implement, and a further exposure draft is expected in the first half of 2012.

Phase 3: Hedge accounting

The IASB has the objective of improving the usefulness of financial statements by fundamentally reconsidering the hedge accounting requirements of IAS 39. An exposure draft was issued in December 2010 covering general hedge accounting. This phase of the project is nearing completion, and a near-final 'staff draft' is expected to be issued soon. The IASB is continuing to debate its proposals on macro, or portfolio, hedge accounting.

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