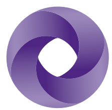

Grant Thornton

An instinct for growth™

2013 EDITION

IFRS Top 20 Tracker

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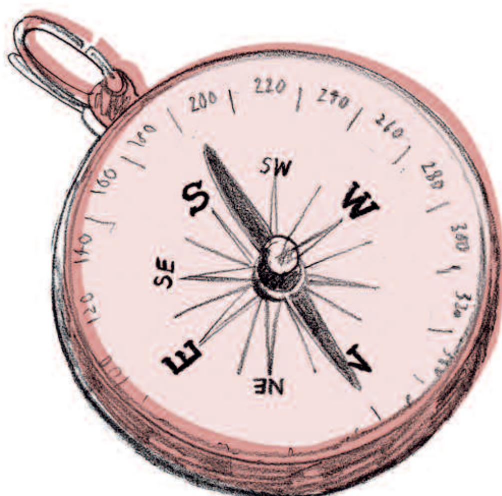
Executive summary

Introduction

The 2013 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 2012.



Key themes

Key themes driving selection of the issues in the 2013 edition are:

- the need for consistency between a company's financial statements and its management commentary
- the effect that adverse economic conditions may have on a company's financial statements, with particular emphasis on the applicability of the going concern assumption
- 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 2013

1 The importance of consistency and clarity

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 necessitates 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.

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 between the management commentary and the financial statements:

Going concern
- is information given about the future outlook for the business consistent with disclosure about why the company is considered to be a going concern?

Accounting policies
- do the accounting policies cover the key types of transaction covered in the management commentary?

Significant changes from the prior period
- has the company explained significant changes from the prior period in policy or presentation?
- where appropriate, are the revised accounting policies clear?

Segment disclosures
- is the description of the company's business and how it is managed in the management commentary consistent with segment disclosures in the financial statements?
- are non-IFRS measures properly reconciled to IFRS disclosures where appropriate?

Events after the reporting period
- is the discussion in the management commentary consistent with that in the financial statements?

Impairment testing
- are the assumptions used in the company's impairment testing consistent with information disclosed in the management commentary?

Overall, the spirit as well as the letter of the IASB's standards needs to be followed and appropriate disclosures provided to give a fair presentation.

2 Economic conditions and public spending cuts

Background

Businesses in many parts of the world continue to feel the impact of subdued economic conditions.

The threat of higher taxes and reduced public spending in the United States combined with the reality of such measures in Europe as countries are forced to implement ‘austerity’ programmes, has exerted a negative impact on growth. As a result, companies in the United States, Europe and further afield have felt the effects, with revenue and profit growth weakening.

Impact on the financial statements

Management will need to assess the impact that these wider economic factors will have on the future outlook for their business and how this will affect their financial statements. In doing so, management should remember that as well as affecting a number of areas of financial reporting, their assessments of current and future economic conditions will also affect the forward-looking components of management commentary. It will be important to ensure that management commentary and the financial statements complement and are consistent with each other.

There are several areas of the financial statements that may be affected by the continuing uncertain economic times, 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 adversely affected by economic uncertainty or by public spending cuts, this will need to be considered 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, which is discussed further in Section 4.

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 the issue of the financial statements.

Impairment

The continuing fragile economic conditions in many areas of the world may affect the key assumptions in value in use calculations used for impairment testing purposes. In this context, management will need to consider the reliability of previous estimates made in earlier years to assess the reasonableness of the assumptions used in the current year. The Eurozone sovereign debt crisis may for example affect the discount rate to be used by some companies in carrying out their impairment tests. The crisis has increased the yield on long-dated government bonds in what are perceived as the weaker countries in the Eurozone, while decreasing the yield on the government bonds of those countries that are perceived as being safe havens. Putting this information into the impairment test calculation may result in a significant increase in the discount rate to be used for the impairment testing of some assets and cash generating units. Impairment testing is discussed in more detail in Section 9.

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 foreign exchange contracts or interest rate swaps. Such instruments are derivatives in the scope of IAS 39 **'Financial Instruments: Recognition and Measurement'**, which requires initial recognition at fair value with subsequent changes in fair value to be recognised in profit or loss. Whilst the use of derivatives may reduce real exposure to risk, it may introduce profit or loss volatility.

There may be an opportunity to manage the profit or loss volatility that may arise through the application of hedge accounting under IAS 39. However, there are onerous conditions which must be met in order for hedge accounting to be applied. 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. Hedge accounting is discussed further in Section 12.

The requirements of IFRS 7 **'Financial Instruments: Disclosures'** are extensive and include disclosures about financial instruments held 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.

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 (see Section 13).

Discounting of defined benefit pension plans

IAS 19 **'Employee Benefits'** requires the rate used to discount post-employment defined benefit obligations to reflect market yields on high quality corporate bonds. In countries where there is no deep market in such bonds, the standard states that market yields on government bonds shall be used.

The predominant past practice has been to consider corporate bonds to be high quality if they receive one of the two highest ratings given by an internationally recognised rating agency, ie 'AAA' and 'AA' only). Difficult economic conditions in some European countries has however resulted in there being a lack of high quality corporate bonds in those countries. This has led some companies to consider using yields on the country's government bonds instead.

In the current economic circumstances using such yields could result in significantly lower defined benefit pension obligations being recognised. This is because the sovereign debt crisis in the Eurozone has resulted in the major rating agencies significantly downgrading the government debt of certain countries to levels that are not considered to be high quality. As a result, the yield on the government debt of those countries has risen significantly. Using such a yield as the discount factor would significantly reduce the obligation recognised. Commentators have questioned whether this would be an appropriate result.

The IFRS Interpretations Committee (IFRIC) have considered the issue and have expressed support for the view that for a liability expressed in Euro, the deepness of the market of high quality corporate bonds should be assessed at the Eurozone level. So for Eurozone countries with no deep market in high quality corporate bonds, companies should look first to high quality corporate bonds issued by companies in other states of the Eurozone before defaulting to government bonds. IFRIC have also noted that they would not expect a company's method of determining the discount rate to be used to change significantly from period to period, other than to reflect changes in the time value of money and the estimated timing and amounts of benefit payments. In view of the significance of these matters, however, IFRIC has recommended the IASB to address them. In the meantime, companies should be aware of IFRIC's initial views.

3 Reducing the disclosure burden

The size of financial statements has grown significantly in recent years as the IASB and other standard setters have added to existing disclosure requirements in the quest for greater transparency. Many people have expressed concern however that the increased size of the notes to the financial statements has created a major burden for preparers, while failing to serve their intended purpose which is to help users understand the numbers in the financial statements.

In reaction, a number of initiatives have been undertaken over the last couple of years, including the publication of reports making recommendations for tackling this problem. These include:

Title	Publisher
Losing the excess baggage	Institute of Chartered Accountants of Scotland and the New Zealand Institute of Chartered Accountants
Disclosure framework	Financial Accounting Standards Board
Towards a disclosure framework for the notes	European Financial Reporting Advisory Group
Thinking about financial reporting disclosures in a broader context	UK Financial Reporting Council

The IASB has itself responded to this growing clamour over disclosure overload in financial statements by holding a public 'disclosure forum' at the end of January 2013 to consider the problem. The IASB will use the feedback received from this meeting, together with the recommendations in the reports mentioned above and similar studies, in developing the disclosure section of its revised Conceptual Framework. However, this work will take some time and any changes to the specific disclosures prescribed in individual standards will take longer still.

Fortunately, there is much that companies can do in the meantime to improve the usefulness and clarity of financial disclosures. Several companies have already taken a fresh look at their approach to disclosures and have successfully reduced 'clutter' while remaining in full compliance with IFRS and other reporting requirements. The table on the following page summarises some of the emerging best practices:

Best practices	Questions to consider
• important messages need to be highlighted and supported with relevant context and not be obscured by immaterial detail • effective cross-referencing needs to be provided and repetition avoided	• is the reporting of material transactions in the period clear and transparent and have appropriate accounting policies been developed? • are accounting policies specific to the circumstances of the company? • have accounting policies for irrelevant and immaterial items been removed, and consideration given to placing information about critical polices, judgements and estimates alongside the related footnotes? • has unnecessary clutter been avoided?
• the language used needs to be precise and explain complex issues clearly • jargon and 'boilerplate' wording should be avoided	• is the language clear? • are disclosures specific to the business' operations and risks?
• items in the financial statements should be reported at an appropriate level of aggregation to convey the essential messages and avoid unnecessary detail • tables of reconciliations need to be supported by and consistent with the accompanying narrative	• has the company summarised appropriately?
• avoid a mentality of erring on the side of caution by seeking to include each and every disclosure requirement regardless of materiality	• has management considered the materiality of the disclosures specified and: – eliminated disclosures that are clearly immaterial – considered relegating less important (but required) disclosures to an appendix?

4 Going concern

Going concern status

The difficult economic conditions that continue to be experienced in certain parts of the world (see Section 2) mean that the assumption that the business is a going concern may not be clear-cut in certain circumstances. As a result, directors may need to make careful judgements relating to going concern.

Management need 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 directors are aware, in making their going concern assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the company's ability to continue as a going concern, those uncertainties 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', 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. Management's review should usually 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 are required to include statements about the assumptions they have made and in particular those which are specific to their 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 approve 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 they consider it appropriate to adopt the going concern basis, identify key risks and say how these have been addressed
- there are material uncertainties and therefore there is significant doubt regarding the entity's ability to continue as a going concern, thus giving rise to the need for additional disclosures under IAS 1.25. It is important to ensure that the material uncertainties are clearly identified in the disclosure given
- 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 reach, 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.

Consistency with other areas

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

Management should consider whether there is information in the financial statements 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 not be overlooked. The going concern disclosures are an opportunity for management to explain why such matters do not affect the status of the company as a going concern.

5 Presentation of financial statements

Presentation is the foundation of financial statements

IAS 1 **'Presentation of Financial Statements'** is fundamental to a set of IFRS accounts. It sets out the basis for their presentation. Whilst application of the standard may appear straightforward, regulators continue to raise significant issues. We discuss some key issues below.

Accounting Policies

IAS 1.117 requires a summary of significant accounting policies including the measurement basis (or bases) used in preparing the financial statements and other policies used that are relevant to an understanding of the financial statements.

Significant policies must be disclosed in a manner appropriate to the complexity of the business and their apparent absence will be challenged by regulators. Equally, policies that are not significant, for example, because the company's business has changed, should be removed to eliminate clutter as their retention detracts from the substantive policies that underlie key areas of reporting (see Section 3).

The policy challenged most often by regulators is that on revenue recognition, for example because the policies presented are too generic and merely regurgitate phrases from the accounting standards without relating them to the company's individual circumstances, business and transactions. This issue is discussed further in Section 6.

Key judgements

The central tenet of IFRS is that it is a principles based reporting framework which requires management judgement in its application. IAS 1.122 requires disclosure of judgements which have the most significant impact on the carrying amounts in the financial statements to enable users to understand the aspects of performance most influenced by management's decisions.

Regulators will challenge apparent omission of disclosure as well as disclosures that are too general rather than being specific as to the precise nature of the judgements management has made. Merely cross-referring to accounting policies or other notes which do not set out the relevant judgements does not meet the requirements of the standard.

The Grant Thornton International IFRS Team has published the 2012 version of its IFRS 'Example Consolidated Financial Statements'. The new version has been updated to reflect changes that are effective for annual periods ending 31 December 2012.

To obtain a copy, please get in touch with the IFRS contact in your local Grant Thornton office.

Key sources of estimation uncertainty

IAS 1.125 requires management to disclose information about the assumptions they make in preparing the financial statements and other major sources of estimation uncertainty that could result in a material adjustment to the reported amounts of assets and liabilities within the next twelve months.

Because of the continuing uncertain economic environment in some parts of the world, greater disclosure of the sensitivity of the carrying amounts of assets and liabilities to the methods, assumptions and estimates underlying their calculation may be necessary than might be the case in more prosperous times. Disclosures should be specific and refer to the actual issues the company faces, and be consistent with any discussion in the management commentary. Generic disclosures or apparent inconsistencies with management commentary are likely to draw the attention of regulators.

Other comprehensive income

Other comprehensive income (OCI) comprises items of income and expenditure that are not included in profit or loss for the period, for example revaluation gains on property, plant and equipment and exchange differences on the retranslation of foreign operations. Items that are required to be included in profit or loss must not be shown in OCI. However, there are items which, though they might appear at first sight to be income or expense, are in fact not presented as part of total comprehensive income because they are regarded as relating to transactions with owners in their capacity as owners. For example, the expense for a share-based payment is recognised in profit or loss. However, some of the related deferred tax may be recognised directly in equity under IAS 12 **'Income Taxes'** and not in OCI because it is regarded as relating to a transaction with owners in their capacity as such (see Section 13).

In some cases, IFRSs require amounts previously recognised in OCI to be recycled and recognised in profit or loss (called reclassification adjustments). IAS 1.92 requires such reclassification adjustments to be disclosed separately, for example amounts reclassified from the cash flow hedge reserve to profit or loss in relation to interest rate hedges (see Section 12). Omission of such disclosures may attract regulators' attention.

Changes to IAS 1 that take effect for annual periods commencing on or after 1 July 2012 will require items of OCI to be analysed in the statement of comprehensive income between amounts that will be subsequently reclassified to profit or loss and those that will not be. Early adoption of this amendment is possible.

Disaggregation

IAS 1.54 specifies line items that must be included in the statement of financial position (balance sheet). Further sub-classifications are presented as appropriate to the company's business. IAS 1.58 requires the exercise of judgement regarding whether to present additional line items based on assessing:

- the nature and liquidity of assets
- the function of assets within the entity
- the amount, nature and timing of liabilities.

For example, aggregating accrued income with prepayments may be inappropriate because the assets are different in nature and liquidity. Similarly, aggregating deferred income with accruals may be inappropriate because those liabilities are different in their nature and timing.

Capital management disclosures

IAS 1.134-6 require disclosures of qualitative information about objectives, policies and processes for managing capital, including a description of what the company manages as capital, and summary quantitative data.

Apparent non-compliance with these requirements continues to draw comment from regulators. These quantitative and qualitative disclosures, by their nature, are likely to be considered material in almost all circumstances. Narrative identification of the component parts of what the company identifies as capital and the relevant balances in the financial statements must be consistent with the quantitative capital management disclosures provided.

Qualitative disclosures must be specific to the company's circumstances and generic boiler-plate disclosures should be avoided. Where there have been transactions or events relevant to capital management, these should be addressed in specific disclosures, for example, share issues or buy backs, or the suspension or reintroduction of a dividend policy.

6 Revenue recognition

Clarity of accounting policies

The revenue recognition policy is often the most important accounting policy in the financial statements. The policy must be clear as to how the principles of IAS 18 **'Revenue'** have been applied to the specific business and each of its significant revenue streams. It should also demonstrate clearly the point at which revenue is recognised and the basis on which it is measured. In particular, where the stage of completion approach has been utilised, the methodology applied should be explained clearly.

Regulators have frequently questioned companies about accounting policies related to revenue recognition. Often reported descriptions do not explain clearly the basis on which the relevant qualifying criteria for recognition required by IAS 18 have been met in respect of the specific income streams of the company concerned.

Regulators have noted that policies are often drafted in broad generic terms or simply repeat text from the standard which does not enable users to understand the transactions entered into or the point at which revenue would be reflected in the income statement. This has led regulators to ask for additional information to help understand the basis on which management has satisfied itself that:

- the significant risks and rewards of ownership of goods have been transferred to the customer
- the stage of completion of services rendered can be determined reliably
- the amount of revenue can be measured reliably
- it is probable that the company will benefit economically from the transaction.

The issues discussed below are of particular relevance when assessing whether revenue recognition policies are appropriate and have been disclosed properly.

Categories of revenue

IAS 18 requires disclosure of each significant category of revenue recognised during the period (IAS 18.35(b)). Categories to be disclosed separately cover revenue arising from:

- the sale of goods
- the rendering of services
- interest
- royalties
- dividends.

The categories of revenue disclosed must be consistent with other information in the financial statements, for example in narrative reports such as the business review and segment disclosures under IFRS 8 **'Operating Segments'**.

Where a category of revenue is disclosed, an accounting policy for that category should also be disclosed. Regulators have noted that the category of revenue for which a policy was omitted most frequently was the rendering of services.

Depending on the nature and complexity of the company's business, it may be necessary to present policies separately for individual components within a category, for example where a range of goods or services is provided.

Stage of completion

Where a company derives revenue from the provision of services, IAS 18.35(a) requires the accounting policy for revenue to disclose the methods used to assess the stage of completion and the amount of revenue to be recognised at each stage.

IAS 18 is not prescriptive as to the methods to be used in determining the stage of completion. However, the method selected must be appropriate to the company's particular circumstances and reflect the revenue earned from provision of services during the period. Hence, the method used must measure reliably the services performed. IAS 18.24 gives examples of potential methods:

- surveys of work performed
- services performed to date as a percentage of total services to be performed
- the proportion that costs incurred to date bear to the estimated total costs of the transaction.

IAS 18 notes that, for the third method above, only costs that reflect services performed to date are included in the costs incurred to date and only costs that reflect services performed or to be performed are included in the estimated total costs of the transaction.

Some companies may seek to use progress payments, advances received from customers or amounts invoiced as the basis for determining the stage of completion. However, these often do not reflect the stage of completion of services performed and regulators are likely to challenge such policies.

Construction contracts

Construction contracts fall within the scope of IAS 11 **'Construction Contracts'**, not IAS 18. Therefore, it is important to identify which standard applies to a particular transaction or category of revenue because the accounting may differ and IAS 11 requires more extensive disclosures.

A construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use. Such contracts, and only such contracts, fall within the scope of IAS 11.

Regulators have noted that it was not always clear from the descriptions provided by companies whose accounts they reviewed whether IAS 18 or IAS 11 was the appropriate standard to be applied in accounting for contracts.

IFRIC 15 **'Agreements for the Construction of Real Estate'** addresses the issue of whether IAS 11 or IAS 18 applies to a particular transaction. Only those agreements meeting the definition of a construction contract are covered by IAS 11. By contrast, an agreement for the construction of property in which the buyers have only limited ability to influence the property's design, for example by selecting a design from a range of options specified by the entity or specifying only minor variations to the basic design, is an agreement for the sale of goods within the scope of IAS 18.

Complex arrangements

Particular care in developing revenue recognition policies is required where arrangements are complex. For example, it may be necessary to apply IAS 18's recognition criteria to separately identifiable components of a single transaction or, conversely, to consider two or more transactions together when they are linked in such a way that the commercial effect cannot be understood without considering the sequence as a whole.

Regulators have noted that particular attention needs to be paid to the revenue policy where there may be other parties with an interest in the financial outcome of a sales transaction, for example where there are franchise-type arrangements or trade is conducted through an agent or distributor. The accounting policy should make clear at what point the transfer of the risks and rewards of ownership occurs and, where necessary, the basis for accounting for the revenue as principal rather than agent. Where the decision is finely balanced, regulators note that it may be appropriate to treat it as a significant judgement and provide enhanced disclosure as required by IAS 1 **'Presentation of Financial Statements'** (see Section 5).

Regulators have also noted that particular care should be taken in relation to descriptions of complex transaction types, such as extended credit sales, long-term projects where discounting may be appropriate, or transactions involving the provision of both goods and services where it should be clear from the description how the various components are accounted for.

7 The statement of cash flows

The importance of the statement of cash flows

Cash is king: understanding how a company generates cash flows has never been more important. In the current economic environment, the ability of a company to convert operating results into cash flows cannot be underestimated. The statement of cash flows shows how a company is generating cash flows and where the money it generates is being spent. Further, as the statement of cash flows is not dependent on how accounting policies are applied, it is less subjective than the primary performance statements and therefore allows a broader comparison of companies.

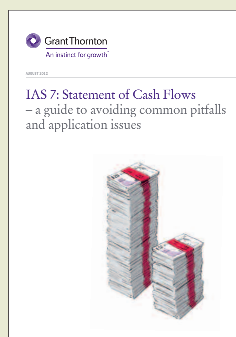
The importance for the statement of cash flows to be properly prepared is apparent from recent actions taken by regulators, who have expressed concerns over companies who do not appear to take as much care in the presentation of their statements of cash flows and supporting notes as they do with other primary statements.

Cash and cash equivalents – what does 'short term' mean?

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 change in value'. However, in today's fast paced, evolving world, how short is 'short term': one day, one week or one month? IAS 7 **'Statement of Cash Flows'** does not define short term but it does say that an investment will normally meet the definition of short term where it has a maturity of three months or less from the date of acquisition. This is generally because with a maturity of three months or less, the investment is normally:

- readily convertible to a known amount of cash and
- will be subject to an insignificant risk of change in value.

In determining whether an investment qualifies as a cash equivalent, the three month time frame can be used as an indicator. However, whether or not the investment meets the above two requirements should be the key judgement in determining its categorisation as a cash equivalent for the purposes of the statement of cash flows.



The Grant Thornton International IFRS Team has published 'IAS 7: Statement of Cash Flows – a guide to avoiding common pitfalls and application issues'. To obtain a copy of the publication, please get in touch with the IFRS contact in your local office.

Identification and classification of cash flows

Under IAS 7 there are three categories of cash flows, namely cash flows from:

- operating activities
- investing activities
- financing activities.

Cash flows must be classified under one of these headings in a manner which is most appropriate to the company's business.

Regulators have been known to pay particular attention to the incorrect classification of cash flows, so it is important to take care when determining the categorisation of cash flows.

Operating activities

Cash flows arising from operating activities are those principally relating to the revenue activities of the company and also those that are not classified as financing or investing activities. Examples of such cash flows include cash receipts from the sale of goods and cash payments made to employees.

Investing activities

Cash flows arising from investing activities are those relating to the acquisition and disposal of long term assets and investments that are not included in cash equivalents.

Only expenditures that result in the recognition of an asset in the statement of financial position should be classified as investing activities. An example of this is the treatment of development expenditure. If the development expenditure is not eligible for capitalisation under the requirements of IAS 38 **'Intangible Assets'**, then the expenditure will not give rise to an asset and, therefore, cannot be classified as an investing activity cash flow. Instead, the cash flows relating to the development expenditure will be classified as operating activities.

Financing activities

Cash flows arising from financing activities will result in changes in the size and composition of the contributed equity and borrowings of the entity. Examples of such cash flows include cash proceeds from issuing shares and cash repayments of amounts that have been borrowed.

Foreign exchange differences

The treatment of foreign exchange differences in the statement of cash flows is a key area which causes problems in practice.

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 operating, investing and financing activities cash flows, and is typically shown at the foot of the primary statement.

The treatment of foreign exchange differences in the consolidated statement of cash flows is another area which can cause problems.

In a group situation, it is often simpler to deal with the foreign exchange differences by preparing a statement of cash flows for each subsidiary in its functional currency and then translate these into the presentation currency for the purposes of preparing the consolidated statement of cash flows.

8 Business combinations

IFRS 3 Revised

IFRS 3 (Revised) **'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 either cause practical problems in the application of the requirements or which are often overlooked are now becoming apparent. Some of these key areas are highlighted here.

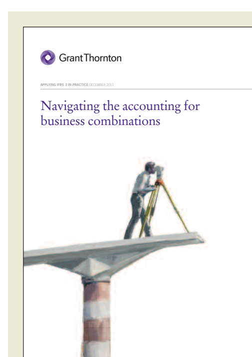
Identifying a business

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 IFRS 3 applies most commonly where one entity acquires another, the definition makes it clear that a business need not be an entity, but can be a collection of assets and a trade. In addition, the collection of activities and assets does not have to be providing returns currently, but must have the ability to do so.

When a collection of assets is combined with activities, it may be difficult to determine whether this constitutes a business. An example of an indicator that a group of assets is a business is where employees are transferred with the acquired assets. Alternatively, the types of assets acquired may give rise to questions, for example, assets arising from research and development.

Regulators have been known to ask companies to provide additional information supporting their accounting for a transaction as a purchase of assets when there was a question as to whether the transaction was a business combination.



The Grant Thornton International IFRS Team has published 'Navigating the accounting for business combinations – applying IFRS 3 in practice'.
To obtain a copy of the publication, please get in touch with the IFRS contact in your local office.

Identifying the acquirer

In all business combinations within 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 is the acquiree. Such business combinations are known as reverse acquisitions.

What is part of the business combination?

There may be transactions or relationships between the acquirer and acquiree in a business combination that do not form part of the business combination itself. Such indicators might be pre-existing relationships or arrangements that are entered into during the negotiation for the business combination. IFRS 3 is clear that any amounts that are not part of what the acquirer and acquiree exchange for control in the business combination are excluded from the business combination accounting. An example of a transaction that is not part of the business combination is a transaction that reimburses the acquiree or its former owners for paying the acquirer's acquisition-related costs.

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 identifiable intangible assets acquired in a business combination should be recognised only if capable of reliable measurement.

Where a business combination is discussed in 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 continue to be concerned that not all identifiable intangible assets that meet the criteria for recognition are appropriately recognised and measured on acquisition.

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.

Shares issued as consideration

IFRS 3 requires the consideration transferred in a business combination to be measured at the acquisition date fair value. This includes any shares in the acquirer which are issued as part of the consideration. Where there is a quoted share price in an active market, the quoted price on the acquisition date is used to determine the fair value of shares issued as consideration.

It is common for the number of shares to be issued to be agreed in advance of the acquisition date, for example based on the share price at the date the purchase agreement is prepared. However, it is the share price at the acquisition date that is used in accounting for the business combination. The result of this is that if, for example, the share price rises between the date at which the purchase agreement is prepared and the acquisition date, the higher share price on the acquisition date is used in determining consideration transferred. This leads to problems in practice where the financial statements show the consideration transferred to be higher than the acquirer had intended, as the acquirer may believe the accounting treatment results in them appearing to have overpaid for the business acquired.

Contingent consideration

It is common for acquisition arrangements to include an amount of consideration for which payment is contingent on the occurrence of a future event, or where the amount to be paid in the future varies dependent on, for example, the level of future profits of the acquiree. Where there is contingent consideration in a business combination, under IFRS 3 this 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.

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.

The accounting treatment that should be applied to these arrangements was considered by the IFRS Interpretations Committee at its September 2012 meeting. At this meeting, it tentatively decided that an arrangement in which contingent payments are automatically forfeited if employment terminates should lead to a conclusion that the arrangement is compensation for post-combination services rather than additional consideration for an acquisition, unless the arrangement is not substantive.

Regulators can be expected to pay close attention to the accounting applied in such situations.

9 Impairment testing

Impairment testing and disclosure

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

What are the key assumptions which need to be disclosed?

IAS 36 requires extensive disclosure of information relating to different stages of the impairment process to be given for each cash-generating unit (CGU) to which significant goodwill is allocated or which has suffered an impairment. In calculating the recoverable amount of a CGU, when based on 'value in use', a number of assumptions will need to be made, which are required to be disclosed by IAS 36.134(d). These assumptions are as follows:

Period of projected cash flows

What is the period over which management has projected cash flows? The projections based on most recent budgets and forecasts approved by management are normally limited to five years, unless a period greater than five years can be justified.

Growth rate

What is the growth rate used to extrapolate cash flow projections beyond the period covered by the budgets? These growth rates are limited to the relevant average for the product, industry, country, etc unless a higher rate can be justified.

Discount rate

What is the discount rate that should be applied to cash flow forecasts? This is discussed further below.

Key assumptions used to prepare projected cash flows

The standard requires a description of each key assumption on which management has based its cash flow projections for the period covered by the most recent budgets and forecasts (IAS 36.134(d)(i)).

Regulators have drawn attention to a number of companies that identified the growth rate used to extrapolate the cash flow projections and the pre-tax discount rate as their key assumptions. Regulators have commented that, whilst these rates are important, they are not key assumptions on which management has based its cash flow projections.

Rather, the growth rate and discount rate are applied to cash flow projections after those cash flows have been estimated. For this reason, the standard includes disclosure requirements in respect of the growth rate and pre-tax discount rates separately and in addition to each key assumption on which the cash flow estimates are based.

Management will need to make assessments about what they consider to be their key assumptions. For example, in a service-based business, a key assumption may be the expected rate of changes to salaries and/or bonuses. For a transport company, a key assumption may be the expected rise in fuel costs.

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.

Regulators have indicated that they may focus in on compliance with this aspect of financial reporting in the future.

Is it acceptable to use a single pre-tax discount rate?

The assumptions underpinning impairment tests must be specific to the CGU. These include, for example, growth rates and discount rates. The discount rate must be a pre-tax rate reflecting current market assessments of the time value of money and the risks specific to the asset for which the future cash flow estimates have not been adjusted (IAS 36.55).

It is not appropriate simply to use an entity-level discount rate, such as the entity's weighted cost of capital, as the discount rate should reflect the current market assessment of the risks specific to the asset or CGU, being the rate of return a market participant would expect given the risks associated with that business unit.

Therefore, if there are specific risks attached to each business unit, different discount rates should be applied to each CGU. Such differences in the risk profile may be as a result of:

- operating in different countries, which may have different currency risk
- operating within different sectors, which may be seen by the market as more or less risky
- sale of different products, resulting in, for example, different price risk attached to costs and different risks that sales price may be driven down by competition.

If all CGUs have been tested for impairment using the same pre-tax discount rate then this may attract the attention of regulators. Regulators have expressed concern in the past over the way in which some companies appeared to have determined their pre-tax discount rates.

How does impairment testing interact with IFRS 8?

IAS 36 requires impairment testing to be carried out at the CGU level and goodwill to be allocated to CGUs (IAS 36.66 and 36.80). A CGU may be no larger than an operating segment under IFRS 8 **'Operating Segments'**.

An operating segment is defined by IFRS 8 as a component of an organisation which:

- engages in business activities from which it may earn revenue and incur expenses
- whose operating results are regularly reviewed by the chief operating decision maker, and
- for which discrete financial information is available.

Once the operating segments have been identified, IFRS 8 then permits some of these segments to be aggregated together for the purposes of reporting segment information provided certain specified criteria are met.

However, even if operating segments have been aggregated for reporting purposes, allocation of goodwill to CGUs must not be at a higher level than the operating segments identified for segmental reporting under IFRS 8 before the application of the aggregation criteria.

If a business has more than one segment, which most do, it is vitally important that goodwill is allocated to CGUs and that the impairment test is performed at the appropriate level. It is not permissible under IAS 36 to 'cross-subsidise' by offsetting a surplus of recoverable amount over carrying value in one CGU against a shortfall in another.

10 Earnings per share (EPS)

Is EPS important?
Yes. The EPS figure is useful in comparing the performance of different companies and is a key metric in performing equity valuations of a business. Further, calculating the figure incorrectly may also attract the attention of regulators. The relevant standard is IAS 33 **'Earnings per Share'**.

Basic earnings per share
The basic EPS figure is the starting point of the calculation and is calculated as:

$$\frac{\text{Profit}}{\text{Weighted average number of shares}}$$

Profit
Profit is the after tax profit or loss attributable to the equity owners of the parent entity adjusted for the effects of dividends and financing costs in relation to preference shares classified as equity. Care should be taken to make sure that the effects of non-controlling interests have been eliminated correctly.

Weighted average number of shares
Shares are generally included in the calculation from the date that the consideration for their issue is receivable. The weighted average number of shares must be adjusted for changes in the number of shares that do not result in a change in resources. For example, in a bonus issue, no cash or other service or asset is received by the company. The adjustment has the effect of assuming that the new number of shares had always been in issue and therefore also adjusts the weighted average number of shares for all periods presented in the financial statements. In addition, shares held by the company ('treasury shares') or, for example, an employee benefit trust should not be included in the weighted average number of ordinary shares in issue.

Diluted earnings per share
A company may have issued warrants to investors or share options to employees that will result in shares being issued in the future, thereby diluting the share capital in the future. The diluted EPS aims to show the impact that such future issues will have on the EPS. Shares are only dilutive where they reduce a profit per share or increase a loss per share from continuing operations.

Continuing and discontinuing operations
IAS 33 requires that EPS is disclosed for continuing operations attributable to the parent entity and the total profit/loss attributable to the parent entity. Where there are only continuing operations, there is no need to provide an additional figure.

However, where there are discontinued activities the company will need to report EPS for continuing operations and the EPS for profit/loss attributable to the owners of the parent on the face of its statement of comprehensive income (or separate income statement if presented). The EPS must also be reported for discontinued activities, either on the face of the primary statements or in the notes to the accounts.

EPS is a measure based on profit/loss attributable to ordinary equity holders of the parent entity. As such, discontinued EPS should also be based on amounts attributable to ordinary equity holders of the parent. The sum of the continuing EPS and discontinued EPS should, therefore, equal the EPS for equity holders of the parent undertaking. Example 1 illustrates such a situation.

Example 1

	CU'000
Profit for the year attributable to continuing operations	14,680
Profit for the year attributable to the disposal group	2,774
Profit for the year attributable to to equity holders of the entity	17,454
Weighted average number of shares in issue (thousand)	768
Calculation of EPS:	**CU**
Continuing EPS (14,680/768)	19.11
Discontinued EPS (2,774/768)	3.61
EPS for equity owners of the parent (17,454/768)	22.72

Share options

Options are dilutive when they would result in the issue of ordinary shares for less than the average market price of ordinary shares during the period. The amount of dilution is the average market price of ordinary shares during the period minus the exercise price. Therefore, to calculate the dilution the standard treats potential ordinary shares as consisting of both those to be issued at the average market price during the period and those to be issued for no consideration.

For share-based payments to which IFRS 2 **'Share-based Payment'** applies, the exercise price should include the fair value of any goods or services to be supplied to the company in the future under the share option arrangement. Example 2 works through such an arrangement.

Example 2

	CU'000
Profit for the year (CU million)	15
Weighted average number of shares in issue (million)	20
Basic EPS (15/20) (CU)	0.75
Weighted average number of unvested share options (million)	7
Average market value of shares for the year (CU)	0.50
Exercise price (CU)	0.30
Unamortised IFRS 2 charge (CU million)	1
Calculation of EPS:	
Adjust exercise price for amortised IFRS 2 charge (CU0.30 + (1m/7m)) (CU)	0.44
Consideration receivable on exercise (CU0.44 x 7m) (CU million)	3.08
Shares issued at market value (3.08/0.50) (million)	6.16
Dilutive number of shares (7-6.16) (million)	0.84
Duted EPS (15/(20 + 0.84)) (CU)	0.71

Adjusted earnings per share

A company may wish to present an adjusted EPS calculation. For example, where Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) is a key measure, management may wish to provide an EPS figure where the numerator is EBIDTA, rather than profit as previously discussed.

Where such a figure is presented, the standard requires that the number of weighted average shares that is used in the calculation is the same as that which is used in the calculation of basic and diluted EPS. If the numerator is not a reported line item in the statement of comprehensive income, a reconciliation must be provided to reconcile the numerator to the relevant line item. Regulators have been known to look closely at this requirement.

IAS 33 requires that additional EPS figures are reported only in the notes and should not, therefore, be reported on the face of the primary statements.

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 so that they are tax-efficient and minimise cash outflows. The accounting requirements for such awards are set out in IFRS 2 **'Share-based Payment'**. This section discusses some key areas which cause problems in practice.

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. A typical example is the requirement for an employee to save in a Save As You Earn scheme. The employee can stop saving but continue providing services. Where this occurs, it is treated as a cancellation of the award by the employee.

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 company'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-Schöles formula is not suitable where there are market conditions.

Other valuation models that are commonly used to calculate the fair value of share-based payments include the Binomial model and Monte-Carlo simulation. Monte-Carlo simulation in particular can be used for share-based payment awards where there are complex market conditions.

Modifications to share-based payments

Companies that put in place 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 financial statements of each entity involved, as well as in the consolidated financial statements.

The entity receiving the services accounts for the award as an equity-settled share-based payment if the award is settled in its own equity instruments or it has no obligation to settle the award, for example because the parent will pay cash. 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 where they are 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 the cost of investment in the subsidiary.

Intermediate parent companies

In some situations the parent company settling the award will not have a direct investment in the subsidiary which is receiving the services, because there is at least one intermediate parent. Where this is the case, there are two possible alternative treatments.

The first possible treatment is that the company settling the award recognises an investment in the subsidiary even though it does not own shares in that subsidiary.

The alternative is that the company settling the award recognises an increase in the cost of investment in the intermediate parent, in which it does own shares. The intermediate parent in turn recognises a capital contribution received and an increase in its cost of investment in subsidiary. Where there are a number of intermediate parent companies in the chain, this would apply in each one.

Either of these treatments may be acceptable in practice; however the first treatment may give a more straightforward solution.

12 Financial instruments: hedge accounting

Why use hedge accounting?

All companies are exposed to financial risks, although the nature of the risk and degree of exposure varies from company to company.

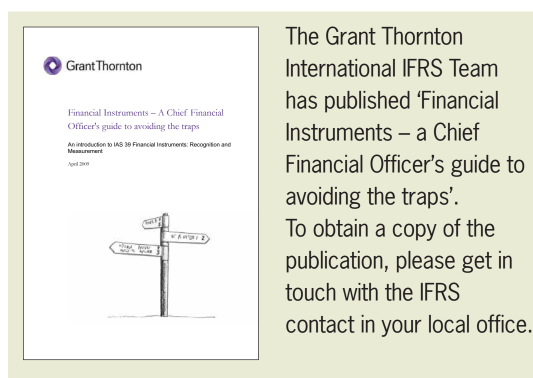
Many companies choose to manage these risks by identifying and monitoring exposures and developing hedging strategies to mitigate risks to acceptable levels. Often these strategies involve the use of derivatives, for example interest rate swaps are used to mitigate interest rate risk, although the use of derivatives is not essential.

A drawback to an active hedging strategy is that derivatives often give rise to significant profit or loss volatility, because IAS 39 **'Financial Instruments: Recognition and Measurement'** requires derivatives to be carried at fair value with fair value movements recorded in profit or loss. Hedge accounting under IAS 39 is a useful tool in mitigating profit or loss volatility, for example, that arising as a result of fluctuations in interest rates. It departs from the default measurement principles in IAS 39 and matches the offsetting effects on profit or loss of gains and losses on the hedging instrument and the hedged item.

Hedge accounting: is it required or optional?

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

There are three types of hedge that may qualify for hedge accounting under IAS 39: cash flow hedges, fair value hedges and hedges of a net investment in a foreign operation (which are accounted for similarly to cash flow hedges).



The Grant Thornton International IFRS Team has published 'Financial Instruments – a Chief Financial Officer's guide to avoiding the traps'.
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Fair value hedge

A fair value hedge is a hedge of the exposure to changes in the fair value of a recognised asset or liability or an unrecognised firm commitment.

An example of where a fair value hedge could be used is where an entity has an exposure to fair value movements in interest rates, as it holds a fixed interest rate loan asset. It takes out a fixed-to-variable interest rate swap to hedge this exposure, so in essence it is paying a variable rate of interest.

Fair value hedge accounting departs from the normal measurement rules for the hedged item, the fixed rate loan, in such a way that gains or losses attributable to the hedged risk (interest rate risk – the change in fair value of the loan) are recognised as adjustments to the carrying amount of the fixed rate loan. These adjustments are recognised in profit or loss to offset the effects of changes in the fair value of the derivative.

Cash flow hedge

A cash flow hedge is a hedge of exposure to variability in cash flows, for example the use of a forward currency contract to hedge the cash flow risk exposure on a foreign currency committed sale.

The effective portion of movements on the hedging instrument is recognised in other comprehensive income (OCI).

Hedge criteria and monitoring

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

The timing of this documentation and effectiveness testing is important. Hedge documentation must be completed at the hedge inception and will need to set out various matters including documentation of the method to be used in assessing effectiveness and the frequency of testing.

Failure to meet the documentation and effectiveness testing requirements will negate the availability of hedge accounting under IAS 39 (even if the hedge appears economically perfect). Thus, a key message is that, if hedge accounting is planned, action is needed on a time-critical and regular basis.

Hedge effectiveness

To qualify for hedge accounting, a hedge must be highly effective in achieving offsetting changes in fair value or cash flows attributable to the hedged risk during the period for which the hedge is designated.

Effectiveness must be tested prospectively at inception and thereafter both prospectively and retrospectively, at a minimum, at the 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, although it does require that 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 gain or loss 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:

- timing: 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
- non-zero starting hedges: If the hedge relationship commenced after the derivative hedging instrument had been entered into, then this would create ineffectiveness

- different terms: 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
- time value: If the intrinsic value of an option is nil on day one (the option exercise price is the same as the price of the underlying) any premium represents the time value of the option and, if included in the documented hedging relationship, it will result in ineffectiveness.

Recycling and cash flow hedges

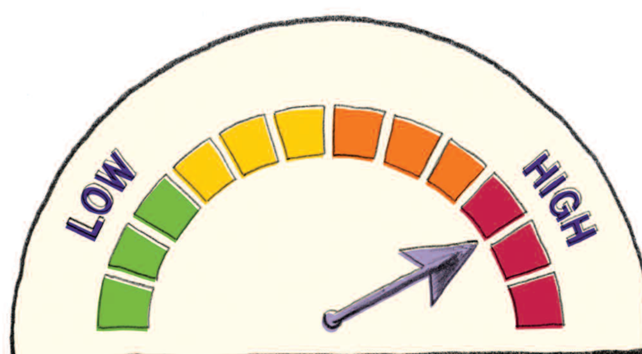
Irrespective of which type of hedge accounting model is applied, the total change in the fair value of the hedging instrument will always be recognised in profit or loss eventually. As discussed above, for fair value hedges the change in the fair value of the hedging instrument is recognised in profit or loss immediately. However, whilst cash flow hedge movements are taken initially to OCI, these movements will, ultimately, also be reclassified to profit or loss. The timing of this 'recycling' will be the earlier of:

- when the hedged item affects profit or loss
- on discontinuation of hedge accounting (with the precise timing of the recycling differing depending on the circumstances of the discontinuation).

For example, a company enters into a forward contract to purchase a fixed amount of foreign currency for a fixed price to hedge the exposure to foreign exchange risk on a highly probable sale in the foreign currency. At the year end, movements in the fair value of the forward contract will be recognised in OCI in accordance with cash flow hedge accounting rules. At the date when the transaction affects profit or loss, in this example when the forecast sale occurs, the cumulative movements on the hedging instrument, which have been recognised in OCI, are reclassified to profit or loss.

For an interest rate swap, recycling will occur at each point that interest on the hedged loan is paid.

In summary, any cumulative balances in a hedging reserve must always relate to hedging instruments where the hedged item has not yet affected profit or loss.



13 Deferred tax and other provisions

Introduction

This Section looks at some key issues relating to the application of IAS 12 **'Income Taxes'** and IAS 37 **'Provisions, Contingent Liabilities and Contingent Assets'**. Both standards have been the subject of comments by regulators.

Taxation

Where is tax recognised?

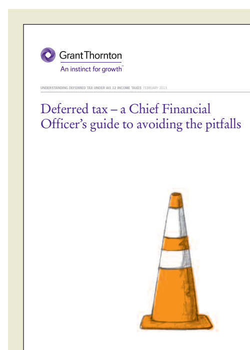
IAS 12 requires current and deferred tax to be recognised outside profit or loss if it relates to items that are recognised outside profit or loss, whether or not in the same reporting period.

Regulators have observed that a common IAS 12 error is the reporting of deferred tax on share-based payments in other comprehensive income rather than directly in equity. Such deferred tax is recognised directly in equity when the cumulative tax deduction available to the company exceeds the share-based payment expense recognised to date.

Tax reconciliation

The effective tax rate (tax charge as a percentage of profit before tax) is seen by many investors as an important performance measure and thus they seek to understand the factors that could affect it in the future. IAS 12.81(c) requires an explanation of the relationship between tax expense (or income) and accounting profit or loss. This is usually achieved by a reconciliation of profit before tax to the total tax charge (including both current and deferred tax).

Regulators have been known to challenge companies where the reconciliation of profit before tax to the tax charge was unclear or appeared inaccurate, for example where deferred tax movements were shown as reconciling items. Companies should provide reconciliations that enable the reader to identify and understand unusual and non-recurring items included in the tax charge for the period.



The Grant Thornton International IFRS Team has published 'Deferred Tax – a Chief Financial Officer's guide to avoiding the pitfalls'.To obtain a copy of the publication, please get in touch with the IFRS contact in your local office.

Measurement

Changes to the rate of tax that a company pays will affect the accounting for both current and deferred 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 requires deferred tax assets and liabilities to be calculated using the tax rates expected to apply in the period in which the asset is realised or the liability settled, based on tax rates that have been enacted or substantively enacted at the balance sheet date. When a change in the tax rate has been enacted at the balance sheet date but takes effect on a future date, companies will need to estimate the periods in which deferred tax assets are expected to be realised and liabilities settled and apply the tax rates that will be effective in those future periods.

Have all deferred tax balances been recognised?

Regulators have been known to ask companies whether deferred tax liabilities should have been recognised in respect of separately identifiable intangible assets acquired in a business combination. Similarly, regulators have questioned companies where it appeared that a deferred tax liability had not been recognised in respect of all taxable temporary differences arising from roll-over relief and capital gains.

Deferred tax assets

IAS 12 requires companies to recognise a deferred tax asset for the carry forward of unused tax losses and credits only to the extent that it is probable that future taxable profit will be available against which the temporary differences can be utilised.

When a company has a history of losses, in the absence of sufficient taxable temporary differences 'convincing other evidence' is required to support the company's judgement that it is probable that future taxable profits will be available against which the tax losses can be utilised. IAS 12 requires that the deferred tax asset should be quantified and the nature of the evidence supporting its recognition disclosed.

Provisions

IAS 37 addresses the measurement and recognition of provisions, contingent liabilities and contingent assets and the disclosures required to enable users to understand their nature, timing and amount. Disclosures under IAS 37 are particularly important given the inherent uncertainties underlying provisions and contingencies.

Regulators have been known to focus on the apparent absence of provisions when other disclosures indicate their existence.

Regulators have in particular challenged companies where items that are generally accepted to be provisions were treated as accruals with no disclosure of their nature or of the expected timing and any uncertainties regarding the amount or timing of the outflows. For example, regulators have found that onerous lease liabilities and restructuring costs were, on occasion, presented as accruals rather than provisions. However, the circumstances indicated that there was still uncertainty regarding their timing or amount and thus they should have been presented as provisions, and appropriate IAS 37 disclosures provided.

Regulators have also questioned the aggregation of provisions where it appeared that the aggregation might include amounts that differ significantly in their nature and/or timing, such that the disclosure requirements of IAS 37 were not met.

14 Operating segments

Background

Investors have consistently said that, in order to understand the performance of a business and its future prospects, they require information to be reported at an appropriate level of disaggregation. If this level is too high, then they are unable to gain sufficient insight and, conversely, where it is too low, important messages can be lost within the unnecessary clutter.

IFRS 8 **'Operating Segments'** was published by the IASB in 2006 with the objective of achieving short-term convergence of IFRS with US GAAP together with the expectation of providing more useful information to users of the accounts.

Chief operating decision maker

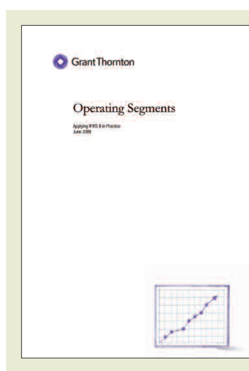
IFRS 8 requires segmental disclosures to be based on the internal information regularly used to assess financial performance and allocate resources between operating segments.

The standard requires operating segments to be identified from the internal information regularly used by the chief operating decision maker (CODM) to monitor financial performance and to allocate resources between operating segments. The identification of the CODM, therefore, is a key step in the application of the accounting standard. If the CODM is identified at too high a level in the organisation, it is quite probable that the resulting segments identified will not provide sufficiently detailed information to satisfy the needs of users.

In this context, companies that identify all of their directors as the CODM should challenge themselves as to whether, in fact, they have correctly identified the individual or group of individuals who perform the function of the CODM.

At its July 2011 meeting, the IFRS Interpretations Committee (IFRIC) noted that it would not expect non-executive directors to be identified as CODMs as this, generally, is not their role, ie they do not make operating decisions.

In the light of these comments made by IFRIC, companies should ensure that they have identified correctly the function of the CODM together with the data set that is regularly used by it to make operating decisions.



The Grant Thornton International IFRS Team has published 'Operating Segments – applying IFRS 8 in Practice'. To obtain a copy of the publication, please get in touch with the IFRS contact in your local office.

Aggregation criteria

The application of the aggregation criteria set out in IFRS 8 enables preparers to combine two or more operating segments into a single operating segment when certain criteria specified in IFRS 8.12 are met. The objective is to obviate the need to disclose information separately about operating segments that have similar future prospects, as such information will be unlikely to add significantly to an investor's understanding of the business.

Application of the aggregation criteria will in most cases require key judgements to be made, in particular, determining whether or not two or more operating segments share 'similar economic characteristics'. The standard does not provide much guidance on what is meant by the term 'similar economic characteristics' other than referring to similar long-term average gross margins. In the light of this, it is important that management disclose the key judgements they will have made, should they determine that two or more operating segments share 'similar economic characteristics,' as well as meeting all the other criteria set out in the standard.

Disclosures

IFRS 8 specifies certain information that should be disclosed in the notes to the accounts both relating to operating segments disclosed and to the entity as a whole.

The entity-wide disclosures (paragraphs 32 to 34) apply to all entities that apply IFRS 8, including those that only have a single reportable segment. The standard helpfully notes that additional disclosure is only required where it is not already provided as part of the reportable segment information already disclosed. In this context, judgement will be required as to whether disclosure already provided for reportable segments based on products and services does, in fact, satisfy the entity-wide disclosures.

For example, an operating segment may sell products and provide after sales maintenance and support. As the sale of equipment and the provision of services are not similar, an analysis of revenue for each of the activities would appear to be required unless already disclosed elsewhere in the notes to the financial statements.

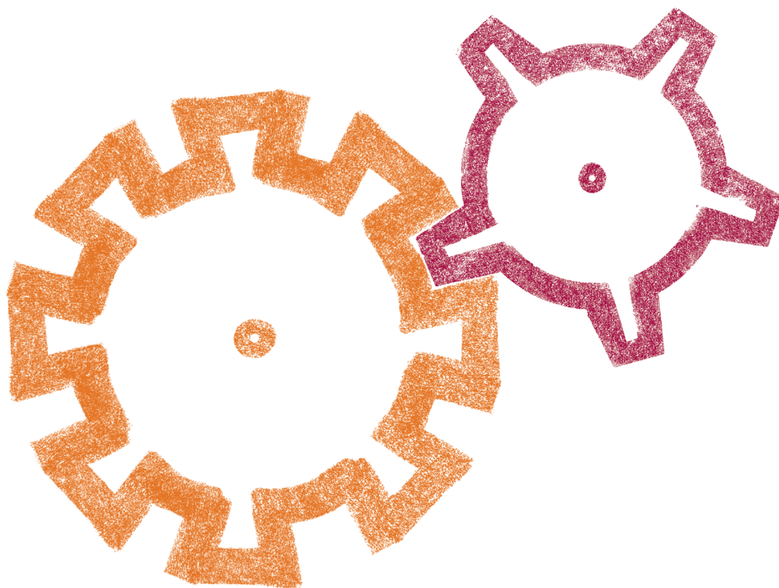
Securities regulator activities

Given the perceived importance of operating segment information for users of the accounts, it is not surprising that regulators have been active in this area of financial reporting.

In this context, the European Securities and Markets Authority (ESMA) published, in November 2011, a report entitled 'Review of European Enforcers on the implementation of IFRS 8 – Operating Segments' and also has been in correspondence with the IASB concerning potential improvements that should be made to the standard. Of these, one relating to the disclosure of additional information relating to the aggregation of operating segments has been included by the IASB in its recent Exposure Draft entitled 'Annual Improvements to IFRSs 2010-2012 Cycle'.

The IASB's Exposure Draft proposes that entities should disclose the judgements made by management in the application of the standard's aggregation criteria, in particular, a brief description of both the operating segments that have been aggregated and the economic indicators assessed in determining that they share similar economic characteristics. It is expected that the new disclosure requirements will be effective for accounting periods commencing on or after 1 January 2014.

However, as the annual improvement is, in fact, only providing clarification of the information that should already be disclosed there is nothing to prevent companies from providing this information in their next financial statements.



15 Net debt reconciliations

Background

Net debt reconciliations are not required under IFRS. However many investors believe they provide valuable information, enabling them to more easily make an assessment of an entity's liquidity and solvency.

A recent report on net debt reconciliations by the UK's Financial Reporting Lab (a body set up by the UK's Financial Reporting Council to improve the effectiveness of corporate reporting in the UK) found that a strong majority of investors indicate they use a net debt reconciliation in their analysis when one is presented. Given the importance of understanding a company's net debt position, many investors attempt to construct these reconciliations themselves if a company does not present them. Companies are therefore well advised to have an awareness of this area of financial reporting.

Net debt reconciliations can be presented in different ways, either as a tabular reconciliation of changes in net debt by component or as a reconciliation of the movement in cash with the movement in net debt. Such reconciliations can highlight important changes in funding that may not be in the cash flow statement, such as the use of finance leases, debt assumed in an acquisition, fair value and hedge adjustments and foreign exchange movements. Where a company's debt structure is complicated, a net debt reconciliation can also help provide an overall picture of the debt structure. Investors are able to better understand how the term net debt is being used by a company, by tying components to what they represent on the balance sheet and in the related notes.

In summary, the reconciliations can provide insight on:

- the company's definition of net debt
- the cash and non-cash drivers of changes in net debt
- the effect of hedging activities on debt
- the measurement of debt for accounting purposes.

Tips for presenting net debt reconciliations

Reconciliations can be particularly important when debt is significant to the capital structure of a company or where there are concerns over cash flow generation. We outline in the table some of the characteristics of net debt reconciliations that investors find most useful.

Tips for presenting net debt reconciliations

- make clear how components of net debt relate to amounts on the balance sheet
  - disclose the corresponding balance sheet line items
  - describe the nature of any adjustments made to these
- adjust net debt to retranslate foreign currency denominated amounts to the exchange rates achieved by hedging, or disclosing the retranslation amount
- make clear the nature of any derivatives included in net debt and whether net debt includes accrued interest
- disclose additional items, or aspects relevant to evaluating net debt; examples include:
  - cash and investments that may not be readily available to pay debt
  - fair value or fair value hedge adjustments to reported debt
  - derivatives related to debt that have not been adjusted for in the company's definition of net debt
- disclose separate movements in net debt
  - make clear whether each is cash or non-cash
  - clarify how they relate to other aspects of reporting
- list movements that differ in nature separately
  - eg separately list significant currency movements that differ from fair value changes that relate to different economic drivers
- separately reconcile key components
  - eg total borrowings
  - derivatives
  - cash and cash equivalents
  - financial investments.

16 Changes to consolidation requirements

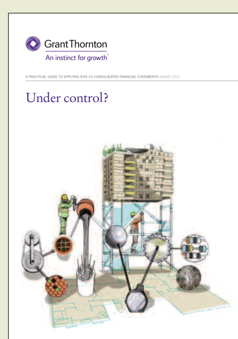
IFRS 10 'Consolidated Financial Statements'

IFRS 10 **'Consolidated Financial Statements'** provides a revised framework to assess when one entity controls another, which will apply to both 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 **'Consolidated and Separate Financial Statements'** will need to be reassessed and some will need to be revised.

IFRS 10 was published in part as a response to the financial crisis. Prior to its publication, consolidation had been addressed by IAS 27 and SIC-12 **'Consolidation – Special Purpose Entities'**. The different requirements of those pronouncements had resulted in some tension, with IAS 27 focusing mainly on control through powers such as voting rights, and SIC-12 focusing more on exposure to risks and rewards of the investee. These tensions came to a head during the financial crisis, when some commentators questioned whether the application of IAS 27 and SIC-12 had resulted in the right things being brought onto companies' balance sheets.

A new, principle-based definition of control

IFRS 10 aims to address these concerns with a new, principle-based definition of control that will be applied to all types of investee (including special purpose entities as well as more conventional voting interest entities) to determine which are consolidated. Significant judgement will be needed in certain situations in applying the definition of control, and in some of those situations the decisions over which entities are consolidated may change (see table on the next page).



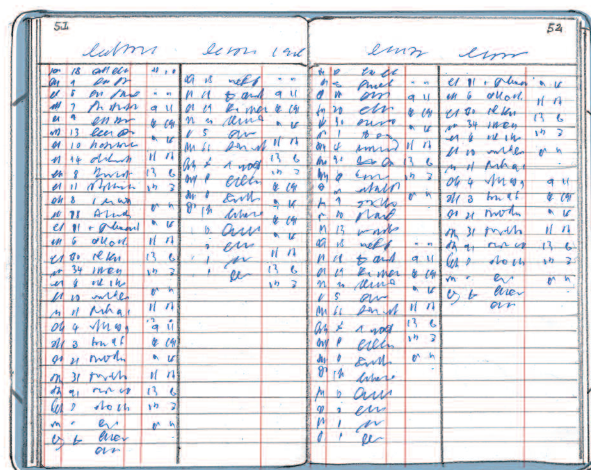
The Grant Thornton International IFRS Team has published 'Under Control – a practical guide to applying IFRS 10 Consolidated Financial Statements'. To obtain a copy of the publication, please get in touch with the IFRS contact in your local office.

Examples of consolidation decisions that may change

Decision	Change
Special purpose vehicles	• exposure to risks and rewards is only an indicator of control under IFRS 10. It does not on its own lead to consolidation. This is a change from the requirements of SIC-12 • IFRS 10 requires a more specific identification of the decisions that have the greatest effect on returns, and who takes them • this change may impact on the consolidation decision for entities that were previously within the scope of SIC-12.
Large minority holdings	• control may exist where other shareholdings are widely dispersed, and an investor holds significantly more voting rights than any other shareholder or group of shareholders.
Potential voting rights	• under IFRS 10, potential voting rights may, in some circumstances, result in control even where they are not currently exercisable • IFRS 10 considers a broader range of indicators on whether such rights are substantive.
Delegated power	• the new guidance in IFRS 10 on principals and agents may impact on consolidation decisions • investment and asset managers in particular may be affected.

Effective date

IFRS 10 is effective for annual periods beginning on or after 1 January 2013 (although certain jurisdictions, including the European Union, have deferred the effective date to 1 January 2014). Certain transition provisions exist. Early application of IFRS 10 is only possible if IFRS 11, IAS 27 (Revised) and IAS 28 (Revised) are also adopted at the same time.



17 Investment entities

On 31 October 2012, the IASB issued 'Investment Entities – Amendments to IFRS 10, IFRS 12 and IAS 27' (the Amendments). The Amendments introduce an exception for investment entities to the well-established principle that a parent entity must consolidate all its subsidiaries. Private equity organisations, venture capital organisations, pension funds, sovereign wealth funds and other investment funds are likely to be particularly interested in the Amendments.

Grant Thornton
An instinct for growth
IFRS News
Special Edition
December 2012
A consolidation exception for investment entities

The Grant Thornton International IFRS team has published a special edition of IFRS News on the IASB publication 'Investment Entities – Amendments to IFRS 10, IFRS 12, and IAS 27'. To obtain a copy of the special edition, please get in touch with the IFRS contact in your local Grant Thornton office.

Definition of an investment entity

The Amendments define an investment entity as an entity that:

a) obtains funds from one or more investors for the purpose of providing those investor(s) with investment management services (investment services condition)
b) commits to its investor(s) that its business purpose is to invest funds solely for returns from capital appreciation, investment income, or both (business purpose condition)
c) measures and evaluates the performance of substantially all of its investments on a fair value basis (fair value condition).

This definition is supported by the provision of several 'typical characteristics' of an investment entity which aim to help preparers in assessing whether an entity meets the definition:

- it has more than one investment
- it has more than one investor
- it has investors that are not related parties of the entity
- it has ownership interests in the form of equity or similar interests.

Requirement	Details
Accounting for subsidiaries held as investments	• subsidiaries held as investments are measured at fair value through profit or loss in accordance with IFRS 9 **'Financial Instruments'** instead of being consolidated. This accounting is mandatory not optional • IFRS 3 **'Business Combinations'** does not apply to the obtaining of control over an exempt subsidiary • the consolidation exception also applies to controlling interests in another investment entity.
Accounting for service subsidiaries	• an investment entity is still required to consolidate subsidiaries that provide services that relate to its investment activities • IFRS 3 applies on obtaining control over a service subsidiary.
Accounting in separate financial statements	• an investment entity's fair value accounting for its controlled investees also applies in its separate financial statements (but see practical insight box) • if the consolidation exception applies to all an investment entity's subsidiaries throughout the current and all comparative periods (ie it has no service subsidiaries) its separate financial statements are its only financial statements.

Accounting requirements for investment entities

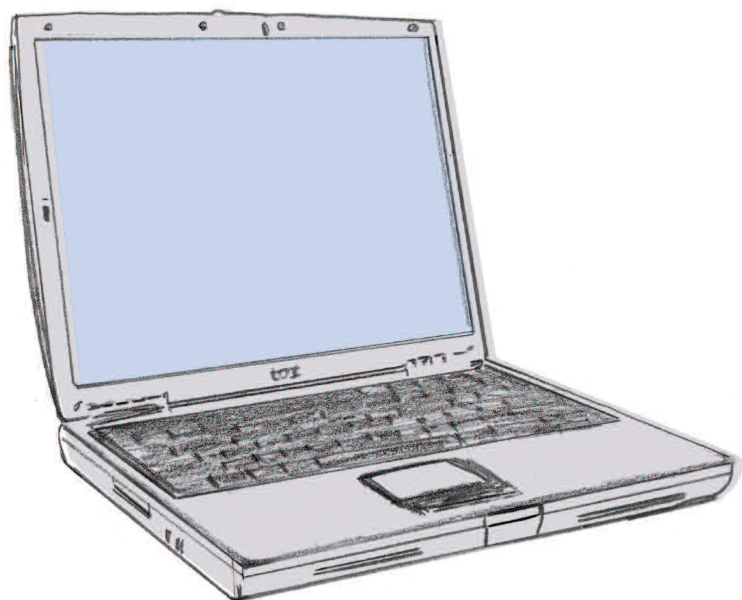
A summary of the accounting requirements for investment entities is set out in the table. The main change is that entities which meet the definition above are required to measure investments that are controlling interests in another entity (in other words, subsidiaries) at fair value through profit or loss instead of consolidating them.

Effective date

The Amendments are effective for annual periods beginning on or after 1 January 2014, one year later than IFRS 10's effective date. The IASB has however permitted early adoption in order to allow investment entities to apply the Amendments at the same time they first apply the rest of IFRS 10. Adopting the consolidation exception early could spare affected entities from much of the time and effort they would otherwise need to spend on reassessing their control conclusions under IFRS 10's new requirements.

Transition simplifications

A number of provisions relating to areas such as the restatement of comparatives and the treatment of subsidiaries divested before the date of initial application are included in the Amendments in order to simplify transition for affected entities.



18 Detail counts…

Related party disclosures

Regulators continue to raise many issues regarding related parties and compliance with IAS 24 **'Related Party Disclosures'**. Whilst these issues do not affect accounting treatment, related party disclosures are often significant to readers of the financial statements, and thus should not be overlooked.

IAS 24.17 requires disclosure of key management personnel compensation in total and split between:

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

Key management personnel include all directors, whether executive or non-executive, and may also include persons other than directors of the parent company, such as leaders of key divisions within the group.

The IAS 24 disclosures focus on the cost recognised by the reporting entity rather than the benefit to the director or employee. This means that the figures disclosed may not be the same as those provided in compliance with statutory directors' remuneration disclosures. For example:

- IAS 24.17 requires disclosure of the IFRS 2 share-based payment charge (or credit) for the year relating to key management personnel, which may not be part of remuneration for statutory purposes
- key management personnel compensation includes employers' social security contributions

Some companies may choose to provide the required disclosure of key management personnel compensation in a remuneration report included in a mangement commentary accompanying the financial statements. This is acceptable provided that a cross reference to the specific information in the remuneration report is included in the financial statements and the information is covered by the audit report. All of the information required by IAS 24 must be included.

Clarity is also required when identifying employees other than directors who are considered to satisfy the definition of key management personnel, especially where key management personnel compensation disclosures are combined with directors' remuneration disclosures.

Financial instruments disclosures

IFRS 7 **'Financial Instruments: Disclosures'** requires large amounts of disclosure in certain circumstances, in particular where companies have financial liabilities measured at fair value. IFRS 7 requires entities to classify financial instruments carried at fair value into a fair value hierarchy according to the levels of inputs into the measurement of financial instruments at fair value. The fair value hierarchy consists of the following three levels:

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

This disclosure requirement applies to all financial instruments carried at fair value. This includes available-for-sale financial assets measured at fair value as well as financial assets and financial liabilities at fair value through profit or loss.

The extent of disclosure required depends on the inputs to the fair value measurement. At its simplest, fair value is measured directly using a quoted market price. However, it might be measured using a valuation model with various inputs, depending on the financial instrument in question. The more detailed disclosure is required for instruments at fair value where the inputs to the fair value measurement are not based on observable market data. Companies that have financial instruments held at fair value need to consider carefully what inputs are used in measuring fair value and therefore where the instrument sits within the hierarchy.

In addition to the fair value hierarchy disclosures, other requirements of IFRS 7 that have previously been identified by regulators as not being done well include the requirements for a company to disclose:

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

Investment property

IAS 40 **'Investment Property'** has two models for accounting for investment property, the cost model and the fair value model. However, even where the cost model is adopted, the fair value of investment properties must still be determined for disclosure purposes.

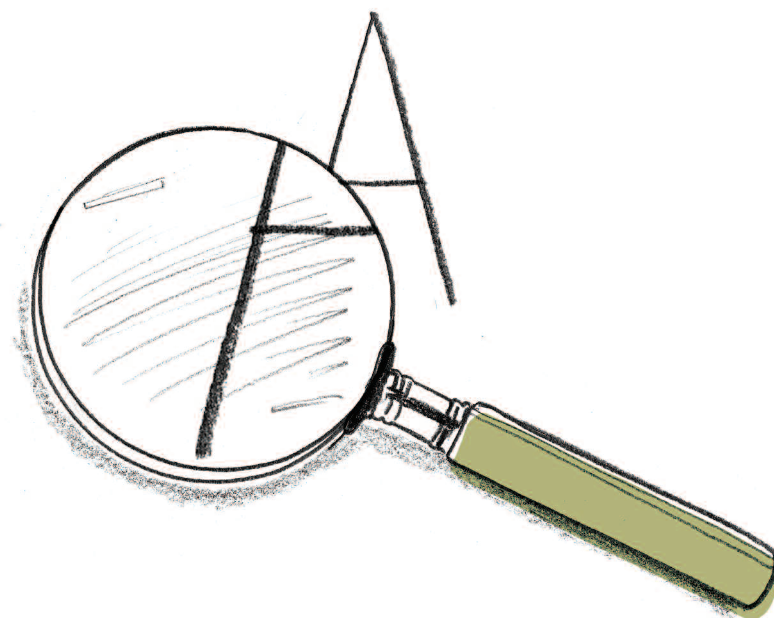
Particularly where the fair value model is applied, significant disclosure needs to be given in the financial statements. Companies often give disclosures similar to those required where the revaluation model is applied to property under IAS 16 **'Property, Plant and Equipment'**; however the requirements of IAS 40 are more onerous.

The disclosures required by IAS 40 include:

- the methods and significant assumptions applied in determining the fair value of investment property
- the extent to which the fair value of investment property is based on a valuation by an independent qualified valuer
- a reconciliation between the valuation obtained and the adjusted valuation where a valuation obtained for investment property is adjusted significantly for the purposes of the financial statements.

Regulators have commented that the disclosure of methods and significant assumptions needs to include a statement as to whether the determination was supported by market evidence or was more heavily based on other factors, which the company should disclose, because of the nature of the property and lack of comparable market data. Regulators have noted that, in their view, this requirement is not satisfied by a statement that the valuation was carried out under International Valuation Standards.

Disclosure as a key judgement may be required regarding how management has distinguished owner-occupied property from investment property. Where classification is difficult, IAS 40 requires the criteria applied to be disclosed.



19 IFRS changes for 2013

A busy year for IFRS

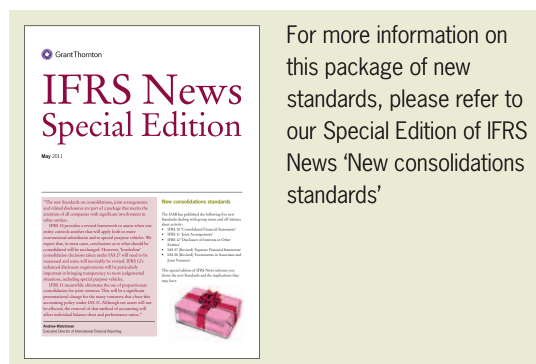
In contrast to 2012, there are a number of new and amended IFRS standards with an effective date of 1 January 2013 (subject to local legislation). At the same time as issuing the new consolidation requirements discussed in Section 16, the IASB issued new standards on joint arrangements and on disclosure of interests in other entities. Other changes include a new standard on fair value measurement and amendments to the accounting for defined benefit pension schemes. With the exception of fair value measurement, the main changes are applied retrospectively – and will therefore need to be reflected in companies' comparative balance sheets from 1 January 2012 (based on the IASB's effective date). However, transitional reliefs may be available in certain circumstances.

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 associates and joint ventures, will need to reassess the accounting treatment they apply. The key points of IFRSs 11 and 12 are covered briefly below (IFRS 10 is covered separately in Section 16).



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For more information on this package of new standards, please refer to our Special Edition of IFRS News 'New consolidations standards'

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 volumes of new disclosures for some companies especially those with material non-controlling interests.

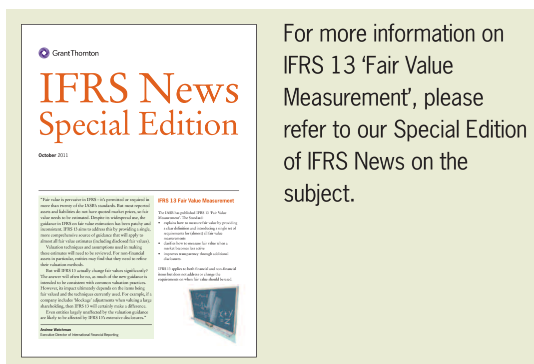
Structured entities are similar to special purpose entities, previously dealt with by SIC 12. The disclosures required by IFRS 12 aim to provide transparency about the risks a company is exposed to through its interests in structured entities.

Fair value measurement

IFRS 13 **'Fair Value Measurement'** 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.

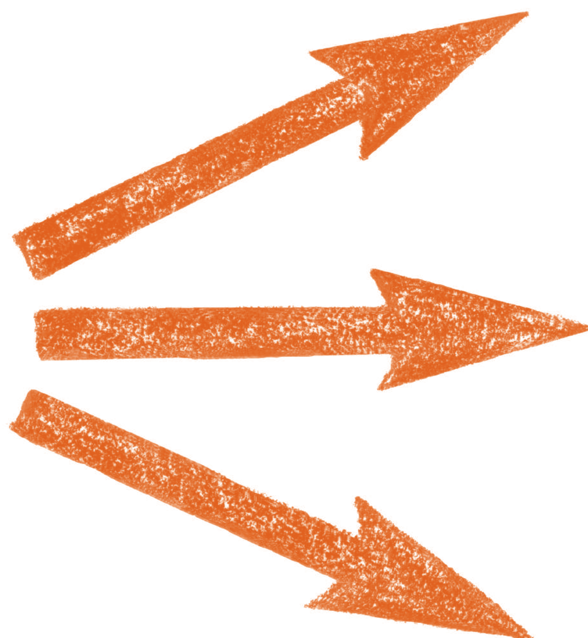


For more information on IFRS 13 'Fair Value Measurement', please refer to our Special Edition of IFRS News on the subject.

Accounting for pension schemes

Amendments to IAS 19 **'Employee Benefits'** will impact on 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 (now referred to in IAS 19 as 'remeasurements') will be recognised in other comprehensive income in the period in which they arise.

In addition, the calculation of net interest cost has changed so 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, normally the market yield on high quality corporate bonds, 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 9

The effective date of IFRS 9 **'Financial Instruments'** draws closer. The standard, which was drafted in response to the financial crisis, will replace IAS 39 **'Financial Instruments: Recognition and Measurement'**.

Although companies can (subject to local legislation) adopt the standard early, it is not yet complete. The current version of the standard addresses the classification and measurement of financial assets and financial liabilities, and derecognition. The IASB continues to work on the requirements for impairment methodology (an Exposure Draft is due for release by the end of the first quarter of 2013) and hedge accounting (this section of the standard is due to be published in the second quarter of 2013).

While the unfinished status of the standard has deterred companies from adopting it (even the requirements on the classification and measurement of financial assets are subject to possible revision as a result of the November 2012 Exposure Draft 'Classification and Measurement: Limited Amendments to IFRS 9'), companies should not ignore the standard as they will need to re-evaluate the classification of all instruments within the scope of IAS 39. In addition to the impact on companies' financial position and reported results, changes to information systems may well be needed. With less than two years remaining to the mandatory effective date of 1 January 2015, companies need to take steps now if they are to complete the necessary assessments and implement system changes in time.

IFRS continues to change

The IASB has a heavy work programme to revamp major areas of IFRS over the next few years, including revenue and leasing. 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.

An Exposure Draft (ED) of a proposed standard 'Revenue from Contracts with Customers was issued in June 2010, followed by a revised ED in November 2011 with a comment period ending in March 2012. The final standard is planned to be issued in the first half of 2013. The effective date for the new standard has yet to be confirmed. It will not be sooner than annual periods beginning on or after 1 January 2015 and may be as late as 1 January 2017. 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 issued its long-awaited 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 first half of 2013, however as yet an effective date for the new standard has not been proposed.

For lessees, the existing operating lease versus finance lease distinction will be removed and replaced by an 'on balance sheet' model. The lessee will recognise a right-of-use asset and a corresponding liability for the obligation to pay rentals. The significant change to the proposals is that whilst all leases will still be on balance sheet, two models are proposed for charging expenses to profit or loss, which will depend on the substance of the leasing arrangement. We will know more once the second ED is released. The IASB is proposing some transitional reliefs but many existing leases will nevertheless need to be restated.

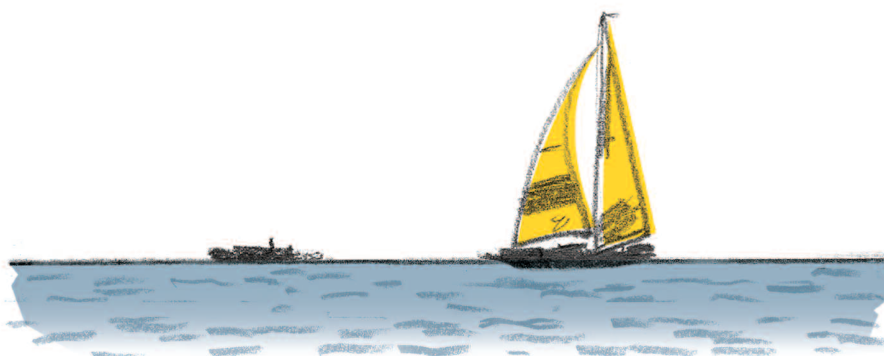
For lessors, the original ED proposed two approaches depending on the exposure of the lessor to the risks and benefits of the underlying asset. However, it appears likely that the proposals for lessors will change in the new ED.

Integrated reporting

There are some potential developments in narrative reporting coming up on the horizon. One of these developments is the creation of a globally accepted integrated reporting framework. The body responsible for the development of this framework is the International Integrated Reporting Council (IIRC).

The ultimate aims of the IIRC are to develop a framework for integrated reporting and to promote its use around the world. The intention is that the framework will pull together the links between an organisation's strategy, governance and financial performance and the social, environmental and economic context within which it operates.

The IIRC is currently at the early stages of a pilot project to develop a framework for integrated reporting. Over 80 organisations are involved in the project, from a range of countries and industries, including our UK member firm, Grant Thornton UK LLP. The project is currently due to run until September 2014 with version 1.0 of the Framework due to be published in December 2013.



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