Grant Thornton

IFRS Top 20 Tracker

2009 Edition

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Introduction

IFRS Top 20 Tracker – 2009 edition

This IFRS Top 20 Tracker takes management through 20 disclosure and accounting issues identified by Grant Thornton International Ltd (Grant Thornton International) as potential challenges for IFRS preparers in 2009. 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.

The issues selected for this publication have been drawn from:

- comments and questions from financial regulators around the world
- practical issues that have become more common in the current economic conditions
- changes to IFRS taking effect in 2009.

Inevitably the current economic conditions are having a significant impact on many companies' financial reporting. A wide range of issues may require increased attention in the current market. These same issues are also attracting increased focus from investors and regulators. This Tracker therefore concentrates on those issues in particular.

In addition, 2009 brings a host of changes to financial reporting requirements under IFRS. Several significant new Standards, amendments to Standards and Interpretations take effect this year. Dealing with these changes efficiently requires early planning and preparation. For this reason some of the later chapters of this Tracker provide a heads-up for management about the most important changes.

This Tracker is not of course a comprehensive list of the issues that companies may need to focus on, nor does it describe the applicable IFRS requirements in detail. Its objective is to help management prioritise by highlighting some of the key issues that Grant Thornton member firm clients may face. Every company is different, and the most important issues in each case will vary based on location, industry and circumstances. Nonetheless we see many common themes and the IFRS Top 20 Tracker aims to share these insights. We hope you find it useful.

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1 IAS 1 - Presentation issues: Significant judgements

1.1 Judgements

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

Due to the nature and extent of the judgements that management has to make, the disclosures will vary significantly from company to company. There can therefore be no model or standard disclosure examples. Management need to assess carefully those areas of judgement that may need disclosure within the financial statements.

This disclosure becomes more important in a period of economic downturn as investors want to know exactly what judgements management have made in relation to the financial statements.

IAS 1.123 includes some examples of the types of judgements that may be required but what is likely to be high up on the list for investors? For example:

- timing of revenue recognition – ie when are the risks and rewards associated with revenue actually transferred
- impairment reviews – particularly if a company has significant goodwill balances
- consolidation of entities where a company does not own the majority of a subsidiary's shares
- lease classification
- whether an outflow of economic resources is probable and hence a provision should be recognised
- debt/equity classification of financial instruments.

Management need to consider whether there are any other specific judgements they have to make due to the business activities that they are involved in. If there are significant judgements that they have to make, these should be included within this disclosure.

[1] All references to IAS 1 in this Tracker are to the most recent version. See section 18 for information of significant changes to IAS 1 made in 2007.

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2 IAS 1 - Presentation issues: Key sources of estimation uncertainty

2.1 Estimates

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

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

IAS 1.129 gives some examples of areas that may be covered and the types of disclosures that can be made in order to help users to understand the judgements:

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

In an economic downturn, this disclosure is just as important as the significant judgements covered in Section 1. Where management make estimates, they will need to ensure that these are appropriate in the current economic environment, for example, assumptions about the future should not be overly optimistic. Areas where estimates are likely to be critically important include:

- future cash flows when assessing going concern
- future cash flows and associated assumptions when considering the possible impairment of goodwill and other assets
- an assessment of what is a reasonably possible change in a key assumption when testing goodwill for impairment
- measurement of provisions
- whether sufficient taxable profits will arise to allow the recognition of a deferred tax asset
- the measurement of a defined pension benefit obligation.

This list identifies some of the potential areas you may wish to consider. However, each company is different and the disclosures need to be considered carefully. Management needs to decide which estimates really are critical to their company.

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3 Going concern issues in the current economic environment

3.1 Going concern

For most businesses, it is assumed that they will continue for the foreseeable future and are therefore a going concern. Under IFRS, management need to ensure that it is reasonable for them to conclude it is appropriate to prepare financial statements on a going concern basis. IAS 1.25 requires that where management 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 shall be disclosed in the financial statements.

This disclosure becomes more important in a period of economic downturn.

3.2 Disclosures

When making financial announcements, management are required to publish statements about the assumptions they have made and particularly those which are specific to their circumstances. In the current environment, there is an increased need to inform users about the nature of the information that they will receive. Management will need to address these reporting challenges early within the timetable they have for preparing the annual report and accounts as this will help to avoid any last minute problems which could cause adverse investor reaction.

For financial reporting purposes, the assessment of going concern 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
- there are material uncertainties and therefore there is significant doubt upon the entity's ability to continue as a going concern, thus giving rise to the potential for additional disclosures under IAS 1
- the use of the going concern basis as not appropriate.

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

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4 Accounting policies – general messages

4.1 Policies

IAS 1 requires disclosure of the recognition and measurement bases used in preparing the financial statements and other accounting policies used that are relevant to an understanding of the financial statements (IAS 1.117). The policies are determined in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors* (IAS 8.7-12).

IAS 1 requires that the policies disclosed are those used that are relevant to an understanding of the financial statements. This means that irrelevant or unnecessary accounting policies should not be stated because to do so might obscure the messages conveyed by those policies that are important to a user of the financial statements. Where policies are relevant and have been applied to material items, they must be stated.

On transition to IFRS, companies will have reviewed their accounting policies and adjusted them where necessary to achieve compliance with IFRS. Companies need to assess their accounting policies each year to ensure that they remain relevant. For example, any accounting policies that have either never been applied or which ceased to apply in prior periods should be deleted. This will improve the understandability of the policies.

Accounting policies included within the financial statements should cover all material items. The policies should be detailed enough to allow readers to understand what specific treatments have been applied. This is particularly important where standards allow accounting policy choices.

Care needs to be taken to use consistent terminology and eliminate local GAAP terms where these have different meanings or are not relevant under IFRS.

A good accounting policy sets out how the item is recognised initially. It then takes the user through the item's subsequent measurement and finally its derecognition. Furthermore, the policy should describe what is actually applied in practice rather than be a generic copy of part of an IFRS standard.

4.2 Changes in accounting policies

A company can change its accounting policy but only when this is required by IAS 8.14. The only permitted (and required) reasons to change an accounting policy are:

- it is required by a standard or interpretation, or
- it results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the company's financial position, performance or cash flows.

IAS 8 also requires disclosures relating to the impact of standards and interpretations in issue but not yet effective. This is discussed further in Section 20.8. Several forthcoming changes will have a significant impact in 2009.

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5 Revenue

5.1 Introduction

The reporting of revenue will require greater attention, as this is an area that will be monitored closely by both regulators and investors. Management will need to ensure that the financial statements contain robust and detailed disclosures relating to their revenue recognition policy and any critical judgements that they have made in relation to the recognition of revenue (see Section 1).

Entities should explain how the underlying principles of the revenue standard are applied to each revenue stream. The absence of this disclosure could lead to companies having the level of their revenue being questioned as there may be a concern that revenue has been recognised too early.

5.2 Timing of revenue recognition

Any changes to the timing of revenue recognition and any other changes to revenue policies should be considered carefully by management.

Progress payments and advances received from customers often do not reflect the services performed. Generally revenue recognition will not follow milestone payments set out in contracts.

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

5.3 Construction contracts

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

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

5.4 Measurement of revenue

Deferred payment terms

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

Bad debt risk

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

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6 Discount rates

6.1 Introduction

IFRSs use discount rates as the basis of a number of measurements of assets and liabilities in the financial statements. The precise discount rate used often depends on the standard under which the item in question is measured.

The current economic conditions have led to various changes to the cost of debt and the cost of equity, the result being that discount rates have changed and are likely to be subject to scrutiny. This section considers the requirements for discount rates in different accounting standards.

6.2 Employee Benefits – IAS 19

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

Over the past year discount rates have moved significantly. There are also a number of standard indices that are typically used for estimating the relevant yield. There can now be a significant difference between the discount rates quoted by these indices.

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

The questions management might need to consider include:

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

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

6.3 Impairment of Assets – IAS 36

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

- the time value of money, and
- the risks specific to the asset for which the future cash flow estimates have not been adjusted.

A rate that reflects current market assessments of the time value of money and the risks specific to the asset is the return that investors would require if they were to choose an investment that would

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generate cash flows of amounts, timing and risk profile equivalent to those that the entity expects to derive from the asset or CGU.

In the current market climate, both the cost of debt and the cost of equity have been rising. The impact is that the discount rate to be used for the value-in-use calculation will also be rising, which will reduce the present value of the cash flows and hence potentially reduce the recoverable amount of the asset or CGU.

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

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

- country risk
- currency risk
- price risk.

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

Again, management will need to clearly articulate their choice of discount rates.

6.4 Other areas that may require discount rates

Share-based payment – IFRS 2

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

Provisions, contingent liabilities and contingent assets – IAS 37

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

Financial instruments: recognition and measurement – IAS 39

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

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

6.5 Conclusion

IFRS requires the use of discount rates in various areas of the financial statements. The current market turmoil in many parts of the world means that these discount rates may have changed substantially compared to those used previously. Management will need to clearly articulate and document the reasons for any decisions they make in selecting appropriate discount rates to ensure their choices of discount rates are in accordance with the relevant accounting standards.

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7 Goodwill impairment disclosures

7.1 Increased focus

Investors and regulators have expressed increased concern over goodwill balances as economic conditions have deteriorated in many parts of the world. When companies report reduced sales and margins goodwill assumptions must be revised.

For groups which have significant goodwill balances, the issues surrounding goodwill impairment will have an impact on disclosures in the annual financial statements. Any group will need to carefully consider all assets which are tested for impairment at the year end.

Goodwill impairment testing and the related financial statement disclosures need to be addressed early in the annual reporting process and as a matter of high priority. We have highlighted below some of the key issues in relation to disclosures.

7.2 Testing at CGU level

IAS 36 *Impairment of Assets* requires impairment testing of goodwill to be carried out at the level of CGUs (or groups of CGUs). It is critically important that goodwill is allocated to the CGUs that benefit from the synergies of the business combination, and that the impairment test is performed at the appropriate level. The allocation of goodwill must be at least down to the level of segments in accordance with IFRS 8. The more CGUs an entity identifies, the more complex the allocation of goodwill becomes. It is not permissible under IAS 36 to 'cross-subsidise' by offsetting a surplus of recoverable amount over carrying value from one CGU against a shortfall in another.

7.3 Assumptions specific to the CGU

The assumptions underpinning impairment tests must be specific to the CGU. These include, for example, growth rates and discount rates. Discounts rates are discussed in more detail in Section 6. The key is to remember that these discount rates must reflect current market assessments of the time value of money and the risks specific to the asset for which future cash flow estimates have not been adjusted. Discount rates will be impacted by the current economic environment, which may have increased both the cost of capital and debt to a company. Furthermore the higher the discount rate the more likely it will be that impairment will arise.

7.4 Projected cash flows

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

Given the current economic climate, it is more likely than previously that new detailed calculations will be required rather than rolling forward and updating previous calculations.

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7.5 Timing of reviews

Annual impairment reviews do not need to be carried out at the year end, but they must be carried out at least annually and generally at the same time each year. In addition to the annual test IAS 36 requires a review at each reporting date of whether there are indications of impairment, and if such indications exist then an impairment test must be carried out. The current conditions increase the likelihood of such indicators being present. Hence, it is not sufficient to rely on an annual test carried out several months prior to the year end if impairment indicators have arisen since the test was performed.

7.6 Disclosures

There are a number of specific disclosures which over the coming months will be specifically looked for by both regulators and investors. The key disclosures are discussed below:

- Information should be specific to the business if it is to be useful and informative
- Narrative disclosures about the way in which key assumptions are identified and quantified need to be detailed and specific; the disclosures should explain management's approach to determining estimates
- Companies should be disclosing information by CGU, especially where there are significant amounts of goodwill allocated to more than one CGU
- Companies should state the extent to which assumptions are consistent with external sources of information; this will be of particular importance with the current economic climate
- The effect of key assumptions made should be discussed and differences between CGUs disclosed
- If a reasonably possible change in a key assumption could give rise to an impairment then IAS 36 requires sensitivity disclosures. Given the movements in the economy over the recent months, this disclosure is more likely to be applicable than previously.

7.7 Conclusion

In the current environment it is very important for companies to provide the required goodwill impairment disclosures. Once the impairment reviews are completed, management should immediately make a start on the required IAS 36 disclosures to enable them to have enough time to prepare high-quality disclosures.

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8 Fixed-for-fixed test – IAS 32

8.1 Introduction

In the current environment, companies trying to raise debt are in some cases being pressured to issue convertible debt rather than straight debt. This difference can lead to very different accounting under IFRS. This section takes management through what the test is and some of the issues in relation to it.

8.2 Fixed-for-fixed test – what is it?

The last year has seen a number of issues due to companies failing the so-called 'fixed-for-fixed test' in IAS 32 *Financial Instruments: Presentation*. This relates to instruments where the issuer is, or may be, required to deliver its own equity instruments in settlement, for example, on conversion of a convertible bond. The issue is that an instrument is equity under IAS 32 only if it is not a financial liability. For a financial instrument or component that will or may be settled in the issuer's own equity instruments to be classified as equity, it must meet the fixed-for-fixed test.

The fixed-for-fixed test is a specific test which if passed under IAS 32 means that a financial instrument has an equity feature. In simple terms, where a financial instrument will, or may be, settled by issue of a company's own equity instruments then the instrument can be equity if and only if the settlement is for a fixed amount of cash or another financial asset in exchange for a fixed number of the company's own equity instruments. It is very important to understand the implications of passing or failing this test as the accounting for each result is very different.

IAS 32.11 contains the definition of a financial liability which has two elements. The first element encompasses where there is a contractual obligation to deliver cash or to exchange financial instruments in a way which is potentially unfavourable. The second element of the definition is where a contract may be settled via an entity's own equity instruments. Some of these contracts can end up as financial liabilities (debt) and some as equity and this is dependent on the fixed-for-fixed test.

8.3 Convertible bond

Let us consider a convertible bond which includes a conversion option. The fixed-for-fixed test determines how this conversion option should be accounted for.

If the test in relation to the conversion option is passed, IAS 32.25 states that it is a compound instrument. The liability component is the obligation to pay cash and the equity component represents the conversion option. The fair value of the liability component on inception would be based on the discounted cash flows in relation to the cash flow obligation discounted by a market rate for a straight (non-convertible) bond. The equity component is simply the residual amount after deducting the debt component.

The situation is more problematic if the conversion option fails the fixed-for-fixed test. A company would now have to account for the entire instrument as a liability, but that liability is effectively a host debt contract with an embedded derivative. Under IAS 39, in most cases, the company would be required to separate the embedded derivative from the host debt contract and carry this embedded derivative at fair value through profit or loss.

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Puttable Instruments and Obligations arising on Liquidation

As from annual periods beginning on or after 1 January 2009 a revised version of IAS 32 *Financial Instruments: Presentation* is mandatory. The amendment will result in some financial instruments that are classified as liabilities at present being treated as equity instruments in the future.

See paragraph 19.4.

To value this conversion option would require the use of valuation experts, which can be costly and time consuming.

8.4 Variation clauses

There is a further complication when convertible bonds include variation clauses. Usually, variation clauses are included to leave equity holders in the same position before and after the transaction, ie the adjustments are there to simply preserve the same relative rights of the shareholders.

The problem is that a number of clauses go above and beyond this and therefore lead to the option failing the fixed-for-fixed test. It only takes one term breaching the fixed-for-fixed test and the conversion option would have to be accounted for as an embedded derivative liability.

Care needs to be taken by any company which is considering issuing new convertible bonds in the current market. The understanding of how to account for these bonds does not need to be left until the year end. As mentioned earlier, failing the fixed-for-fixed test can lead to completely different accounting and disclosures for a convertible bond.

8.5 Amendment of conversion terms

Due to the financial pressure that some companies are facing, it is likely to become more common for lenders to agree to amendments to conversion terms rather than recalling debt. If this occurs, a company will need to consider carefully how this amendment is impacted by the IAS 39.40 requirements regarding the treatment of substantial modifications to instruments. If the amendment leads to substantially different terms, IAS 39 requires it to be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.

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9 Financial instruments – recognition and measurement issues

9.1 IAS 39

IAS 39 *Financial Instruments: Recognition and Measurement*, is a complex rules-based standard that presents many companies with major challenges. The standard establishes the principles for recognising and measuring financial instruments.

9.2 Amendments

The IASB issued an amendment to IAS 39 in October 2008: *Reclassification of Financial Assets – Amendments to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 7 Financial Instruments: Disclosures*. The amendments are part of the IASB's response to issues raised by the credit crisis. The amendments introduce into IFRS a similar (but not quite the same) possibility of reclassifications that is already permitted under US GAAP. The amendments permit an entity to:

- reclassify non-derivative financial assets out of the fair value through profit or loss category in particular circumstances
- transfer from the available-for-sale category to the loans and receivables category a financial asset that would have met the definition of loans receivables if the entity has the intention and ability to hold the financial asset for the foreseeable future.

The effective date of the amendment is 1 July 2008, enabling companies reporting according to IFRS to use the reclassification amendments now.

9.3 Embedded derivatives

Embedded derivatives continues to be a challenging area for many entities. In Section 8, we discussed the fact that if a conversion option within a convertible bond fails the fixed-for-fixed test then a company has an embedded derivative to account for.

An embedded derivative is simply a derivative contained within a larger host contract. This means that derivatives do not have to be individual contracts and can be embedded into any financial instrument or non-financial contract and these derivative terms can act like a free-standing derivative.

One of the main problems when identifying embedded derivatives is that a number of them are created inadvertently through market practices or common contract arrangements. It is easier to identify embedded derivatives that have arisen from deliberate financial engineering.

Some common examples are early payment options (eg issuer has option to repay loans early) or foreign currency sales orders or purchase orders. Embedded derivatives are required to be separated from their host contract and carried at fair value through profit or loss (ie same treatment as standalone derivatives) unless they are deemed closely related to the host contract. There are detailed rules within IAS 39 as to what is deemed closely related.

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It is crucial to look at each financial instrument based on a clear understanding of its contractual terms. If embedded derivatives are not spotted until the last minute, this can have a significant impact on whether the company's results timetable can be met, as normally companies will need specialist valuation help to fair value embedded derivatives.

9.4 Hedge accounting

Hedge accounting is purely optional under IFRS but entities may choose to use it to counteract the profit volatility of derivatives which hedge a hedged item. However, hedge accounting is not a free choice. A company cannot simply decide during the year end reporting process to hedge account because detailed prescriptive documentation is required at the inception of the hedge. Furthermore, many hedges are precluded from hedge accounting because of the detailed IAS 39 rules. In addition there are complex effectiveness tests to negotiate.

If you are considering hedge accounting, here are some of the potential issues to watch out for:

- Hedging documentation needs to be detailed, it must identify both the hedged item and hedging instrument and also identify how effectiveness will be tested including frequency
- Testing of effectiveness – is the ineffectiveness of hedges really nil? Based on our experience effectiveness is rarely 100% and therefore one would always expect to see disclosed the impact of hedging ineffectiveness
- Recycling for cash flow hedges should be accounted for and disclosed within the financial statements. Where there is a cash flow hedge, the financial statements would be expected to include the recycling of cumulative fair value remeasurements on the hedging instrument. Those fair value remeasurements which have been deferred in equity, should be recycled when the hedged item affects profit or loss or is recognised as a non-financial asset or liability.

9.5 Impairment of financial assets

All financial assets that are not measured at fair value through profit or loss are subject to IAS 39's impairment requirements. Applying the requirements is likely to be very significant in current economic conditions. Some of the key issues are discussed below.

IAS 39's impairment model follows a two-step approach. First, an entity assesses at the end of each reporting period whether there is any objective evidence that a financial asset is impaired. Second, if any such evidence exists the entity determines the amount and records the impairment loss in the income statement.

The rules for both measurement and recognition of impairment losses differ between the measurement categories in IAS 39. For financial assets measured at amortised cost an entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant. Financial assets that are not considered to be individually impaired are then also assessed based on groups of similar financial assets. The amount of the impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows.

For available-for-sale equity investments the key issue to consider is whether a decline in fair value below cost is a result of an impairment. If so, that decline is removed from equity and recognised as an expense in profit or loss - a so-called reclassification adjustment. These instruments are impaired when there is objective evidence of impairment, or there is a significant or prolonged decline in fair value. This requires the use of judgement based on a careful analysis of the specific facts and

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circumstances of each case. An impairment loss on available-for-sale equity investments is recognised in profit or loss but cannot be reversed though profit or loss.

For available-for-sale debt instruments objective evidence of impairment is based on IAS 39's guidance for debt-type assets and can be broadly described as evidence that the debtor may have difficulty in paying. An impairment loss on available-for-sale debt instruments is recognised in profit or loss and may be reversed through profit or loss in certain circumstances.

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10 Financial instruments – new and existing disclosures

10.1 IFRS 7 Key issues

IFRS 7 *Financial Instruments: Disclosures* was effective for accounting periods beginning on or after 1 January 2007. This disclosure standard has had a significant impact on all IFRS financial statements.

It is critical that the disclosures surrounding financial instruments comply fully with IFRS 7's extensive requirements - especially given the current economic downturn in many parts of the world.

The experience to date with IFRS 7 has shown a number of key areas where companies are having difficulties producing IFRS 7 compliant disclosures. Some common disclosure issues arising in practice are set out below.

Furthermore, management should also take notice of the recent amendments to IFRS 7 effective from 1 January 2009. These are described in paragraph 10.9.

10.2 Disclosure of IAS 39 classifications

IFRS 7.8 requires the disclosure of the IAS 39 *Financial Instruments: Recognition and Measurement* categories of financial assets and financial liabilities included in the financial statements. These disclosures are usually given in the notes. However, this disclosure has sometimes either been omitted or been incorrect when provided. Fundamentally, companies must be able to identify and categorise their financial assets and liabilities to enable them to comply with IAS 39 and compile IFRS 7 disclosures.

10.3 Maturity analysis and liquidity risk (financial liabilities)

Appendix B to IFRS 7 gives the detailed rules that companies must follow. The key points to note are:

- Analysis should cover all financial liabilities (including trade payables) and items outside the scope of IAS 39 but within IFRS 7 (eg finance leases)
- The amounts included in the analysis should be contractual undiscounted cash flows therefore this amount will not equal that shown in the balance sheet
- Time periods should be analysed according to the earliest date on which the entity could be required to pay.

It is important to note that the maturity analysis is in addition to the requirement to provide summary data on how the entity manages liquidity risk, based on information used in the business. It is also important to explain how liquidity risk will be managed. This might require reference to:

- undrawn loan facilities
- significant concentrations of funding lines
- ability to sell financial assets within an appropriate timescale in order to meet cash outflow obligations.

Slightly amended requirements on liquidity risk disclosures take effect for annual periods beginning on or after 1 January 2009 (see paragraph 10.9).

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10.4 Sensitivity analysis disclosures

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

10.5 Significant concentrations of risk

IFRS 7.34(c) requires disclosure of concentrations of credit risk, liquidity risk or market risk unless apparent from other disclosure. For the current reporting periods, here are some matters to consider:

- Concentrations of credit risk – this is relevant if a company is exposed to individually large balances or a small number of counterparties. These counterparties need not be named but some disclosure is necessary
- If a company is reliant on a small number of funding sources then this may give rise to liquidity risk
- Concentrations of exposure to foreign currency risk are also relevant.

10.6 Past due disclosures

Where a debtor has not paid within its contractually due date then it becomes 'past due'. IFRS 7 requires disclosure of the ageing of past due receivables. This disclosure is important in respect of trade receivables. This disclosure is not the same as an analysis of ageing of receivables.

10.7 Hedge accounting disclosures

When companies adopt IAS 39 hedge accounting, IFRS 7 has specific disclosures. These details are included within IFRS 7.22-24 but in general require:

- clarity in the description of the hedged items and instruments
- clarity of the underlying accounting entries
- disclosure of the ineffectiveness
- disclosure of when the cash flows are expected to occur and when the impact is expected to affect profit (for cash flow hedges).

10.8 Economic downturn – what to watch out for

There is a general need for robust disclosures in relation to financial instruments. Fair value disclosures may not be straightforward given less active markets and more complicated market assumptions (see discussion of new requirements in paragraph 10.9). Furthermore, in relation to credit and liquidity risk, there are potentially more past-due and impaired items to disclose. Management will also need to give close consideration to the credit quality of all unimpaired items. On top of that there is the requirement for sensitivity analysis; no more is a reasonably possible change in an interest rate just 0.5%. Finally, management will have to consider carefully any defaults or breaches in relation to financing and the level of disclosure that will be required.

The level of IFRS 7 disclosures are likely to be more onerous as companies will need to disclose more information in relation to their financial instruments.

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10.9 Fast track amendments effective from 2009

In March 2009 the IASB issued Amendments to IFRS 7 *Financial Instruments: Disclosures*. The amendments aim to improve the information that companies provide on how they measure the fair values of financial instruments and on liquidity risk. The amendment to IFRS 7 is one of the 'fast track' amendments issued by the IASB as part of its response to the credit crisis. The amendments should be applied in annual periods beginning on or after 1 January 2009. Comparative amounts need not be restated. Accordingly, management needs to prepare systems and procedures to capture the necessary information to comply with the requirements for 31 December 2009 year ends.

Fair value measurement

IFRS 7 now requires more information on how the fair value of financial instruments is measured. The amendments require disclosure of a three-level fair value hierarchy for all financial assets and liabilities that are measured at fair value in the statement of financial position.

The new disclosures cover:

- the level of the fair value hierarchy into which fair value measurements are categorised in their entirety;
- the fair value measurements resulting from the use of significant unobservable inputs to valuation techniques (for these measurements, the disclosures include a reconciliation from the beginning balances to the end balances);
- the movements between different levels of the fair value hierarchy, and the reasons for those movements.

The underlying concept is to disclose the 'quality' of the measurement of financial instruments. These new disclosures are expected to be significant for investors - especially in circumstances where financial markets are inactive. Accordingly, management should give themselves enough time to prepare for the disclosures.

Liquidity risk

The second part of the amendments to IFRS 7 improve the disclosures of an entity's liquidity risk. Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset. In accordance with the amendments an entity discloses:

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

The most important change compared to the previous IFRS 7 liquidity risk disclosures relates to derivative financial liabilities. The revised liquidity disclosures should enable entities to explain more clearly how they manage liquidity risk in relation to derivatives they hold, and should be beneficial. Liquidity risk is important for investors in the current economic conditions. In particular, investors are likely to be interested in detailed information about how an entity manages its liquidity risk.

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11 Consolidation issues

ED 10: IASB proposes new Consolidation standard

The IASB has published an Exposure Draft entitled 'Consolidated Financial Statements' as part of its response to the credit crisis. The proposals are part of a comprehensive review of off balance sheet activities being conducted by the IASB over the use of special structures by reporting entities, particularly banks, in managing securitisations and other more complex financial arrangements.

The G20 and other commentators had raised concerns over whether the current requirements resulted in the right things being brought onto the balance sheet. The proposals aim to address these concerns by presenting a new, principle-based, definition of control of an entity that would apply to a wide range of situations and be more difficult to evade by special structuring. The proposals also include enhanced disclosure requirements that would enable an investor to assess the extent to which a reporting entity has been involved in setting up special structures and the risks to which these special structures expose the entity.

11.1 Introduction

There are several potential issues relating to consolidation in the current economic conditions. There is the potential need for management to reassess which companies are included within their consolidated financial statements, especially if the conditions have forced companies to amend contractual and other relationships with special purpose entities. Accounting treatment and measurement issues for business combinations will also be under the spotlight.

11.2 Consolidation of controlled entities

All entities that are controlled should be consolidated. IAS 27 *Consolidated and Separate Financial Statements* defines control as the power to govern the financial and operating policies of an entity so as to obtain benefit from its activities. IAS 27 also requires that any currently exercisable options to acquire a controlling interest in an entity are taken into account when assessing control.

Special purpose entities

Some entities, often called special purpose entities (SPEs), are set up to achieve a narrow and well-defined objective. Whilst a company may be able to demonstrate that these entities are not controlled under the normal criteria set out in IAS 27, SIC-12 *Consolidation – Special Purpose Entities* still requires consolidation of that entity when the substance of the relationship between the entity and the SPE indicates that the SPE is controlled.

If a company has had to change its contractual relationships with its SPEs then management will need to reconsider their consolidation evaluations. There may also be a need to make additional disclosures where decisions about whether an entity should be consolidated constitute a material judgement about the application of the company's consolidation policy.

11.3 Business combinations

Distress business combinations

During the current economic downturn, there are likely to be business combinations involving companies in distress. In these circumstances, the completion timetable for such combinations can be extremely short. Management need to ensure that they give themselves enough time to consider the accounting implications. There is an increased likelihood of material misstatements where business combinations have taken place in distressed situations.

Fair value measures

IFRS 3 *Business Combinations* requires the use of fair values for determining the cost of a business combination and the values ascribed to the identifiable assets and liabilities acquired. Measuring these fair values can be problematic, especially in the current economic climate. It is therefore important for management to ensure that any fair value calculations are robust, or as robust as possible given the market uncertainties. IAS 1 disclosures relating to judgements and estimates must also be considered (see Sections 1 and 2).

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12 Taxation – areas affected by the credit crisis

12.1 Offsetting

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

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

In the current economic environment there is likely to be additional focus on whether tax liabilities, and hence total liabilities, are understated through netting. Any balances that have been netted off are also likely to be scrutinised more closely to ensure that any deferred tax assets can be recognised.

12.2 Recognition of deferred tax assets

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

The assessment of recovery of deferred tax assets is likely to depend on the consideration of whether it is probable that sufficient future taxable profits will be available relating to the same taxation authority and the same taxable entity in the same period as the reversal of deductible temporary differences.

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

The recognition of a deferred tax asset when there are not sufficient taxable temporary differences will require convincing evidence that such taxable profits will occur. In the current economic environment, such evidence may be more difficult to identify, and if this evidence is not available then the deferred tax asset cannot be recognised.

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

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13 Share-based payments

13.1 Share-based payments

The remuneration package for a significant number of employees includes share-based payments. The current economic conditions have impacted on share-based payments in several ways.

13.2 Equity-settled share-based payments

In the current environment, some equity-settled share-based payment awards will fail to vest due to performance conditions not having been met. The accounting effects of options failing to vest depend on the reasons. If non-vesting relates to actual or expected failure to meet a non-market performance condition (eg earnings target) this results in a reversal of any previous share-based payment expense. By contrast, non-vesting due to failing a market condition (eg target share price) does not result in any reversal.

However, it is irrelevant whether equity-settled share-based payments, such as share options, are worth anything to the employee at the time they vest, for example on completion of a required period of service (a service condition). Options may be out of the money and thus not exercised, but that has no impact on the accounting under IFRS 2. Share-based payment charges are only reversed through failure to meet a service condition or a non-market performance condition.

13.3 Modifications and cancellations

The recent falls in the equity markets in many parts of the world may mean that companies are considering modifying the terms of their options to ensure that they remain attractive to the employees to which they have been granted. Any modifications that increase fair value, such as a reduction in the exercise price, will result in an additional share-based payment expense. The additional expense is based on the incremental fair value, ie the difference between the fair value of the modified equity instrument and that of the original equity instrument, both measured at the date of modification. The existing share-based payment expense based on the grant-date fair value of the original award continues to be recognised too.

Furthermore, if a company is considering cancelling an existing equity-settled share-based payment, this usually results in an increased expense in the period of the cancellation, rather than a reduction. This is because cancellations are accounted for as an acceleration of the vesting of the award.

13.4 Valuation of share-based payments

Most share-based payment awards need to be valued using a valuation model. Many of the key inputs into these models (eg share price, volatility and expected dividends) will be affected by the current market conditions. Management will need to ensure that they are satisfied with the inputs used in these valuation models as there is the potential for companies to be challenged on the figures that they disclose.

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14 Post-employment benefits – defined benefit pension schemes

14.1 Closing or curtailing schemes

Pension scheme curtailments and settlements may become more common in consequence of restructuring programmes and other cost-cutting initiatives. Where there is a curtailment or settlement, IAS 19 *Employee Benefits* requires the defined benefit obligation to be remeasured using current actuarial assumptions before determining the effect of a curtailment or settlement. Where management are considering an action that would result in either a curtailment or settlement, the need to obtain actuarial advice at or around the date of the event should be considered.

14.2 Valuations and assumptions

Plan liabilities and the discount rate

Section 6.2 discusses the choice of an appropriate discount rate for defined benefit pension schemes.

Plan assets

IAS 19 requires plan assets to be stated at their fair value. Both the property and equity markets have seen significant decreases in recent months. Therefore the fair value of plan assets at the reporting date is likely to be significantly lower than in previous periods, although the impact on the statement of financial position may be offset by the effect of increased discount rates on the defined benefit obligation.

Expected return on plan assets

IAS 19 permits actuarial gains and losses to be recognised immediately in other comprehensive income. Where this option is chosen, the income statement shows the expected return on plan assets with the difference between the actual and expected return on plan assets shown as an actuarial gain or loss in other comprehensive income.

This year the actual return on plan assets is likely to be negative. Also expectations of the expected returns on equity and property may well need to be revisited in light of recent market turmoil. As a result the expected return on plan assets is likely to attract a lot of attention as the selection of an inappropriate rate could lead to misstating profit for the year.

14.3 Scheme-specific funding

IFRIC 14 *IAS 19 – The Limited on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction* is effective for accounting periods beginning on or after 1 January 2008.

In most situations, the presence of Scheme-specific Funding, (SSF), is only relevant where the scheme is in an IAS 19 surplus position. However, in certain circumstances the impact of this interpretation is to increase the liability recognised for defined benefit pension schemes. Such an increase will typically occur when:

- the trustees and the company have agreed SSF
- paying the SSF would result in an asset position under IAS 19 and the asset that would be created by payment of the SSF would not be available as either a reduction in contributions or a refund.

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15 Foreign currency translation issues

15.1 Foreign currency

The accounting for foreign currency translation is governed by IAS 21 *The Effects of Changes in Foreign Exchange Rates*. Common problems with foreign currency disclosure are discussed below.

15.2 Functional versus presentation currency

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

There is no choice of functional currency and IAS 21 provides guidance which takes the form of primary and secondary indicators of economic factors and circumstances that should be considered in determining the functional currency.

The presentation currency is the currency in which the financial statements are presented. This is a matter of choice. Where the presentation currency is different from the functional currency, IAS 21.53 requires the entity to state this fact and disclose the reasons for the choice of a different presentation currency.

15.3 Mechanics of translation

IAS 21.21 requires that a foreign currency transaction should be recorded initially by applying to the foreign currency amount the spot exchange rate between the functional currency and the foreign currency at the date of the transaction. The standard permits the use of an average rate for a period provided there is no significant change in rates during the period. The use of average rates is discussed further in Section 15.5.

The procedure for translating assets and liabilities at each balance sheet date will depend on whether the assets and liabilities are monetary or non-monetary in nature. Monetary items are required to be translated into the functional currency at the spot exchange rate at the reporting date.

The treatment of non-monetary items depends on whether the item is measured at historic cost or fair value. There is no retranslation for items measured at historic cost; they remain recorded at the historic transaction date foreign exchange rate. Those non-monetary items recorded at fair value are translated using the exchange rates at the date when the fair value was determined.

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15.4 Consolidated financial statements

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

- Exchange differences on intra-group balances do not cancel out on consolidation. Although the actual intra-group balances cancel out, the exchange differences reported in the entity's individual income statement continue to be recognised in consolidated profit or loss. Furthermore, these exchange differences affect the IFRS 7 currency exposure and sensitivity disclosures
- The assets, liabilities and results of individual entities are translated into the parent's presentation currency. Whilst assets and liabilities are translated at the closing rate, IAS 21 requires the actual rate to be used for results, though the average rate may be used if it is a reasonable approximation (see Section 15.5)
- For the same reason, goodwill and fair value adjustments arising on an acquisition of a foreign operation are retranslated at the balance sheet closing rate.

15.5 Use of average exchange rates

As stated above, the use of average exchange rates over a period to translate foreign currency transactions into functional currency is permitted if the average rate is a 'reasonable approximation' of the actual rate on the transaction date. The appropriateness of using average rates (or the period over which the average is determined) may need to be reconsidered if applicable exchange rates have fluctuated significantly over short periods. Similar considerations apply to translating the results of foreign operations and translation into a presentation currency (where applicable). Given the fluctuations in the foreign currency markets in recent months the use of average rates may be harder to justify.

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16 Events after the reporting period

16.1 Events after the reporting period

Management are required to monitor events which are favourable or unfavourable and that occur between the reporting date and the date when the financial statements are authorised for issue. These requirements are established within IAS 10 *Events after the Reporting Period*. The monitoring of these events is even more important during this period of economic downturn, for example how often at present do we read in the newspaper that another company has gone into administration? If events occur after the reporting date that effectively destroy the going concern status of a company, IAS 10.14 requires a company to prepare its financial statements on a non-going concern basis.

There are two types of events after the reporting date:

- Adjusting events – these provide evidence of conditions that existed at the balance sheet date
- Non-adjusting events – these are indicative of conditions that arose after the balance sheet date

The standard contains examples of both types of events and we shall look at some of those specific events.

16.2 Adjusting events

Adjusting events are required to be recognised in the financial statements. Some of these adjusting events will have more importance to investors than previously:

- Impairment of assets – for example the insolvency of a major customer or the sale of inventory at a significantly lower value than the value of inventory at the reporting date
- Costs of assets purchased – has the fair value been assessed correctly especially if there is a bargain purchase; could intangible assets actually have been impaired at the point of purchase?
- Is there the potential for a call on an investment that a company cannot fulfil?

16.3 Non-adjusting events

Material non-adjusting events are required to be disclosed within the annual financial statements. Some of these events will become more important in the eyes of investors over the coming months. Below are some examples of potentially material non-adjusting events. Management should consider giving careful consideration to the required disclosures, as part of the requirement of IAS 10 is to disclose an estimate of the financial effect:

- A major business combination after the reporting date or disposing of a major subsidiary
- Announcing plans to discontinue an operation of the group
- Announcing or commencing the implementation of a major restructuring of the group
- Abnormally large changes after the reporting date in asset prices or foreign exchange rates.

16.4 Conclusion

The post reporting date events review will need to be considered carefully by management. The interest in these disclosures by investors will mean increased need for clarity and depth of these disclosures.

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17 IAS 23 - new standard on borrowing costs

17.1 Introduction

The revised IAS 23 *Borrowing Costs* applies to accounting periods beginning on or after 1 January 2009, and thus 31 December 2009 year ends (including interim reports for that reporting period). The previous version of IAS 23 allowed a choice: the benchmark treatment was to recognise borrowing costs as an expense, and the allowed alternative treatment was to capitalise eligible borrowing costs that were directly attributable to the acquisition, construction or production of a qualifying asset. The revised IAS 23 does not permit a choice and capitalisation of borrowing costs will therefore become mandatory.

17.2 Prospective application

IAS 23 (Revised) will represent a change in accounting policy for many entities as under the old standard it was common for borrowing costs to be expensed. The change in policy, however, is applied prospectively to borrowing costs incurred in relation to qualifying expenditure for which the commencement date for capitalisation is on or after the effective date.

This means that, where the commencement date for capitalisation of borrowing costs on a particular asset is prior to the effective date, the revised Standard will not apply and the entity will continue not to capitalise borrowing costs on such assets if their previous policy had been to expense. The entity will therefore only apply the revised Standard to new assets. However entities may elect to designate an earlier date from which to apply the standard.

17.3 Qualifying assets

Management should develop an accounting policy to identify the entity's qualifying assets. In many cases this will require the use judgement as the standard does not include quantitative thresholds for the identification of qualifying assets. Furthermore, management should consider the exemptions for capitalisation of certain inventories and assets measured at fair value through profit or loss.

17.4 Borrowing costs eligible for capitalisation

The basic principle is that borrowing costs that are eligible for capitalisation are those borrowing costs that could have been avoided if the expenditure on the qualifying asset had not been made. However, the application of this principle is often difficult and requires the use of professional judgement.

The rules for eligible borrowing costs are different whether borrowings are specific or general. For specific borrowings the amount of eligible borrowing costs is the actual amount of borrowing costs incurred, while for general borrowings the standard requires the use of a capitalisation rate. Management should therefore at an early stage identify an entity's specific borrowings in order to determine the eligible pool of borrowing costs.

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Where qualifying assets are financed by a combination of general and specific borrowing costs, management should develop an appropriate accounting policy to identify the amount of borrowing costs to capitalise.

For many types of costs, such as for example exchange differences and derivative gains or losses, the standard does not include specific application guidance to identify the eligible pool of borrowing costs. Therefore, the application of IAS 23 in this area is difficult. For these items, management needs to develop an appropriate accounting policy.

17.5 Group situations

In our experience, companies often find IAS 23 difficult to apply in group situations. Management should be aware of the following key issues:

- The treatment of external and intra-group borrowing costs in the separate financial statements of the parent or individual financial statements of a subsidiary; in general, intra-goup borrowing costs are capitalised in individual financial statements if the reporting entity has both intra-group borrowing costs and a qualifying asset
- The treatment of external and intra-group borrowing costs in consolidated financial statements of the parent; intra-group borrowing costs are eliminated and cannot be capitalised
- Problems arising in consolidated financial statements when qualifying assets are constructed by one group entity and borrowing costs incurred by another; in general, external borrowing costs incurred by one entity is capitalised also for qualifying assets in another group entity.

17.6 Conclusion

IAS 23 is a significant standard for most entities, as many companies finance qualifying assets with borrowings. The new standard requires the use of judgement in many areas and may be complex to apply. For entities with a 31 December 2009 year end the new accounting requirements are mandatory (including interim reports for that reporting period) and accordingly management needs to give themselves enough time to develop appropriate accounting policies.

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18 Changes to the primary statements in 2009 (IAS 1 as revised in 2007)

18.1 Introduction

The revised version of IAS 1 *Presentation of Financial Statements* is mandatory for periods beginning on or after 1 January 2009 and must be applied retrospectively. IAS 1 is critically important to any reporting entity under IFRS, as it sets out the basic framework for a set of IFRS financial statements.

The revised standard is effective for 31 December 2009 year ends and will also impact on interim financial reports for this reporting period. Interim reports will need to comply with the standards adopted at year end.

18.2 Statement of comprehensive income

Perhaps the most important change is the requirement to present all items of income and expense recognised in the period in either a single 'statement of comprehensive income' or in two separate statements (an 'income statement' and a 'statement of comprehensive income'). Comprehensive income includes normal profits and losses along with other gains and losses that are reported outside profit or loss in accordance with IFRS. These items of other comprehensive income include revaluation surpluses, actuarial gains and losses and changes in the fair value of available-for-sale financial assets. These items, previously charged or credited to equity, will in future be reported separately from owner transactions such as dividends and changes in share capital.

The new requirements will focus attention on comprehensive income as a performance indicator in addition to the more traditional net income sub-total, and could result in a change in the way analysts read the financial statements.

The new requirements also mean that the 'statement of recognised income or expense' (SORIE) is no longer permitted.

18.3 Changes to primary statement titles

The amended version of the Standard also makes changes to the titles of the primary financial statements, with

- the term 'statement of financial position' replacing 'balance sheet'
- 'statement of cash flows' replacing 'cash flow statement'
- 'statement of comprehensive income' replacing 'statement of recognised income and expenditure' as explained above.

While these changes in title have attracted considerable attention, their use is not mandatory. Instead preparers may be wise to focus on a change that has attracted less attention but could have a major impact - the need to make additional comparative disclosures in particular circumstances.

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18.4 Additional third statement of financial position

IAS 1 as amended in 2007 introduces a requirement to present an additional balance sheet (or statement of financial position) as at the beginning of the earliest comparative period in a set of financial statements (including related notes) if during the current period the entity:

- changes one or more of its accounting policies retrospectively
- makes a retrospective restatement in order to correct an error
- reclassifies items in its financial statements (IAS 1.39).

A requirement for an additional statement of financial position is not triggered by:

- changing an accounting policy prospectively
- 'recycling' a gain or loss from other comprehensive income to profit and loss, which is referred to as a 'reclassification adjustment' in IAS 1.92-96.

18.5 Conclusion

Management should now be thinking of the effects of adopting IAS 1 (as revised in 2007) on the presentation of the financial statements. As noted, the changes come into effect for 31 December 2009 year ends and accordingly will be applicable for interim reports for that reporting period.

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19 Other key changes to standards in 2009

19.1 Introduction

This Top 20 Tracker, by its nature, is not a comprehensive checklist of IFRS requirements. This section highlights a selection of areas where there is the potential for challenges over the coming accounting year due to revisions and amendments of standards that take effect for accounting periods beginning on or after 1 January 2009.

The requirements of the revised versions of IAS 23 and IAS 1 is highlighted in sections 17 and 18.

19.2 IFRS 8

IFRS 8 *Operating Segments* replaces IAS 14 *Segment Reporting* with effect from annual periods commencing on or after 1 January 2009. Restatement of comparative information is required when IFRS 8 is adopted, unless the necessary information is not available and the cost to develop it would be excessive, though this is unlikely to be justifiable.

IFRS 8 introduces new disclosure requirements for companies preparing financial statements under IFRS. It requires entities to adopt the 'management approach' to reporting on their operating segments. Therefore, the information to be reported in annual financial statements will be the same as that used by management internally for evaluating segment performance and deciding how to allocate resources to operating segments. IFRS 8 makes consequential changes to IAS 34 *Interim Financial Reporting*. IFRS 8 will need to be addressed in good time for interim reports in the first year in which IFRS 8 is applied.

IFRS 8 requires the amounts disclosed to be based on the measures reported internally. The management information disclosed may be prepared using non-IFRS measurement methods.

IFRS 8 retains the same general scope as IAS 14. It requires entities whose equity or debt securities are publicly traded and entities that are in the process of issuing equity or debt securities in public markets to disclose segment information.

19.3 Amendments to IFRS 2

The Amendment to IFRS 2 *Share-based Payment – Vesting Conditions and Cancellations* is effective for periods beginning on or after 1 January 2009. The amendment affects only equity-settled share-based payments. It introduces a new term, 'non-vesting conditions' and requires that the calculation of grant date fair value takes into account non-vesting conditions, and the possibility of these not being met. As application of the amendment is retrospective, this means that previous calculations of grant date fair value will need to be restated where there are non-vesting conditions, so even though the amendment is not effective for December 2008 year ends, it is worth starting to identify non-vesting conditions now and calculating the impact on the grant date fair value.

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The impact of this amendment will be particularly significant on Save As You Earn (SAYE) schemes as the condition requiring an employee to save is a non-vesting condition. If an employee stops saving, this is treated as a cancellation.

19.4 Puttable financial instruments and obligations arising on liquidation

In annual periods beginning on or after 1 January 2009 a revised version of IAS 32 *Financial Instruments: Presentation* is mandatory. The amendment will result in some financial instruments that are classified as liabilities at present being treated as equity instruments in the future. It affects certain instruments that:

- the holder is entitled to redeem (referred to as 'puttable instruments'), and
- impose on the entity an obligation to deliver a pro rata share of the net assets of the entity only on liquidation.

Common examples of puttable instruments include interests in a partnership, shares in a co-operative organisation and units issued by collective investment vehicles. The classification of some such instruments may therefore be changed by this amendment. However, instruments that are currently regarded as liabilities will be classified as equity only if a number of strict conditions are met.

Although the amendment is narrow in scope, it will have a very significant impact on entities that are affected.

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20 Detail counts - don't forget…

20.1 Introduction

A key message is that detail counts. This section highlights a selection of detailed areas where there is evidence that many companies encounter difficulties in achieving IFRS compliance.

20.2 Discontinued operations

Classification as held for sale

The classification of an item as held for sale under IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* have a number of impacts on the financial statements, for example:

- a write down if the asset's fair value less costs to sell is less than its carrying value immediately prior to classification as held for sale
- suspension of depreciation on an asset held for sale.

The correct classification of an asset as held for sale is important to ensure that the financial statements fairly reflect the position and performance of the company.

Fair value less costs to sell

As mentioned above, assets held for sale need to be written down to fair value less costs to sell if this is lower than the carrying value of the asset immediately prior to classification as held for sale. Where an item is classified as held for sale, an assessment of the asset's fair value less costs to sell will be required. In the current economic environment, management will need to make a detailed assessment of the fair value less costs to sell to ensure that any further write down has been recognised and therefore no material misstatement is included within the financial statements.

20.3 IAS 24 Key management personnel compensation

IAS 24 *Related Party Disclosures* prescribes the disclosure in relation to related parties. IAS 24 requires entities to consider key management personnel as related parties of the entity. The extent to which senior management meet the definition of key management is a matter for management's judgement (and may encompass more individuals than simply the parent company management). IAS 24.16 prescribes the disclosure required in relation to key management personnel compensation. This will not necessarily be the same as disclosure of directors' remuneration in many jurisdictions around the world.

The most common omission from IAS 24 key management personnel compensation disclosures is the amount given by way of share-based payments. Here, the disclosure under IAS 24 relates to the cost recognised by the company under IFRS 2 *Share-based Payment* for awards to key management personnel.

20.4 Exceptional items

In contrast with local GAAP in many jurisdictions, the term 'exceptional items' is not used in IFRS. The closest parallel in IFRS is in IAS 1, which states that additional line items are included on the face of the separate income statement (or statement of comprehensive income) "…when such presentation is relevant to an understanding of the entity's financial performance" (IAS 1.85)

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and "when items of income or expense are material, an entity shall disclose their nature and amount separately" (IAS 1.97). The disclosure required by IAS 1.97 may be either on the face of the separate income statement (statement of comprehensive income) or in the notes.

If an entity describes amounts in its IFRS financial statements as exceptional items, an accounting policy should be provided in accordance with IAS 1.117 to explain the entity's policy for characterising such items as exceptional. Typically, such items will be material items which individually or, if of similar type in aggregate, need to be disclosed by virtue of their size or incidence because of their relevance to understanding the entity's financial performance.

The term exceptional items should not be confused with 'extraordinary items' which does not exist in IFRS - all income or expenses are ordinary items (IAS 1.87).

20.5 Property, plant and equipment

The residual values and useful lives of items of property, plant and equipment must be reviewed at least at each year end under IAS 16 *Property, Plant and Equipment*. Residual values are based on current values that could be obtained for the item in its end of useful life condition, and may therefore need to be adjusted downwards to reflect depressed market conditions.

20.6 Inventory accounting

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

20.7 Provisions and contingent liabilities

Restructuring plans give rise to issues over the point in time at which a provision is recorded. Only expenditures directly related to the restructuring may be included in any provision. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* sets out extensive conditions that need to be met for a restructuring provision to be recognised.

Some executory contracts, such as property leases and long-term supply agreements, may become onerous as a result of the entity no longer expecting to utilise the goods, services etc that it is obligated to purchase.

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

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20.8 Standards in issue not yet effective

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

Our current view is that the disclosures need cover only standards and interpretations that are expected to have an impact by changing an accounting policy or significant disclosures. This would include revisions to existing standards that are expected to have an impact, as well as new standards. The change in accounting policy would usually affect recognition or measurement but would also extend to changes in presentation or significant disclosure changes (eg those arising from the introduction of IFRS 8). Where a major new standard is issued (eg a new business combinations standard) it would be helpful to mention this, even if it will have no current impact.

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