IFRS Top 20 Tracker

2014 edition

Contents

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Executive summary

Introduction

The 2014 edition of the IFRS Top 20 Tracker takes management through the top 20 disclosure and accounting issues identified by Grant Thornton International Ltd as potential challenges for IFRS preparers.

The member firms within Grant Thornton International Ltd – 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 Ltd, 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 2013.

Key themes

The 2014 edition of the IFRS Top 20 Tracker has been organised into five Sections, allowing readers to concentrate on the following overall themes in the publication:

- presentation issues
- areas of regulatory focus
- complex areas of accounting
- standards effective for the first time
- issues on the horizon.

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
March 2014

Presentation issues

1. The importance of consistency and clarity

Looking at the financial statements holistically

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 Strategic 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 holistically, in order to ensure that they both complement and are consistent with each other.

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

Regulators question inconsistencies

Regulators will look for inconsistencies between information given in different parts of a company's management commentary and its financial statements. For example, regulators have frequently challenged companies that provide a segmental analysis in their management commentary but then describe their operating segments differently in the notes to their financial statements.

Regulators frequently 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 the assumptions and outlook that underpin the impairment review and going concern assessment, and information about risks, uncertainties and critical judgements and estimates.

Points to consider

We set out below some points to help management in achieving consistency between an entity's management commentary and its financial statements:

Statement	Commentary
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? • is information in the management commentary on factors such as the status of debt facilities, including amounts drawn and undrawn and remaining and details of covenants, consistent with that in the financial statements?
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. 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 volume 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
July 2011	Losing the excess baggage	Institute of Chartered Accountants of Scotland and the New Zealand Institute of Chartered Accountants
July 2012	Disclosure framework	Financial Accounting Standards Board
July 2012	Towards a disclosure framework for the notes	European Financial Reporting Advisory Group
October 2012	Thinking about financial reporting disclosures in a broader context	UK Financial Reporting Council
December 2013	Financial Reporting Disclosures: Market and Regulatory Failures	The Institute of Chartered Accountants in England and Wales

The IASB has itself responded to this growing clamour over disclosure overload in financial statements with a number of new initiatives, including a new staff group that will focus on this issue.

In January 2013, it held a public 'disclosure forum' to consider the perceived problems with disclosure, which was followed by a Feedback Statement on the findings from the meeting. As well as summarising the discussions, the Feedback Statement announces the IASB's intention to take action in three main areas:

1. amendments to IAS 1 'Presentation of Financial Statements' – the IASB intends to make narrow scope amendments to IAS 1 to address perceived impediments to preparers exercising their judgement in presenting their financial reports
2. materiality – the IASB will seek to develop educational material on materiality with input from an advisory group
3. a separate project on disclosure – the IASB will consider as part of its research agenda the broader challenges associated with disclosure effectiveness.

The IASB will also use the feedback received in developing the disclosure section of its revised Conceptual Framework. The Discussion Paper 'A Review of the Conceptual Framework' published in July 2013 sets out several proposals to this effect. The IASB envisages certain short-term steps being taken as a result, including narrow scope amendments to IAS 1 as well as some longer-term ones. The longer-term ones suggested include the replacement of IAS 1 'Presentation of Financial Statements', IAS 7 'Statement of Cash Flows' and IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors', as well as the revision of disclosure requirements in individual IFRSs.

This work will take some time, however, 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 following table 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 policies, 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? • is the focus on entity-specific disclosures? Are disclosures specific to the business's operations and risks? • has related information been linked so as to tell the story of the company in a consistent manner? • has repetition been reduced as far as possible? • has care been taken to avoid generic statements?
• **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**	• is the focus on communication of relevant information to investors? • has the company summarised appropriately? • has immaterial information been excluded? • has an effort been made to limit more marketing-related information?
• **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?

3. Presentation of financial statements

Presentation is the foundation of financial statements

IAS 1 'Presentation of Financial Statements' is fundamental to a set of IFRS financial statements. 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.

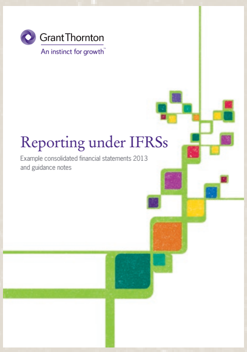
Significant policies must be disclosed in a manner appropriate to the complexity of the business and their apparent absence will be challenged by regulators. Equally, policies that are not significant, for example because they concern activities or transactions that the company no longer undertakes, should be eliminated. Retaining information about obsolete accounting policies detracts from the substantive policies that underlie key areas of reporting (see the Section on Reducing the Clutter). Regulators have noted that significant accounting policies could be included in the financial statements in the most appropriate order for the issuer, starting with those policies considered most material and relevant as well as highlighting any options chosen in their application, when allowed.

The policy challenged most often by regulators in practice 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 the Section on Revenue.

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 the apparent omission of disclosures 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 2013 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 2013.

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. Regulators have reminded preparers that sources of estimation uncertainty should be reviewed regularly to ensure that they are relevant for each set of financial statements.

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. Regulators have also noted that, in line with the examples provided in IAS 1.129, they expect preparers to provide the sensitivity of carrying amounts to the methods, assumptions and estimates underlying their calculation, including reasons for that sensitivity.

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 the Section on Income Taxes).

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 the Section on hedge accounting). Omission of such disclosures may attract regulators' attention.

Changes to IAS 1 that became effective for annual periods commencing on or after 1 July 2012 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.

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.

New Standards

Regulators have noted that disclosure of new Standards issued but not yet effective is relevant when the new Standard might have a material impact on the financial statements or if that impact is not known.

Future developments

As reported in Section 2, the IASB is currently undertaking an initiative to address the perceived burden of disclosures. Discussions are continuing in relation to this initiative. Some of the IASB's tentative decisions include:

- additional guidance should be added to the materiality section of IAS 1 to clarify that the concept of materiality should be applied to the specific disclosure requirements set forth in a Standard or Interpretation. Materiality should be assessed both for primary financial statements and for the notes to the financial statements
- wording should be included in the materiality guidance in IAS 1 to highlight that disclosing immaterial information could obscure useful information
- IAS 1.54 and IAS 1.82, which deal with presentation of line items in the statement of financial position and the income statement respectively, should be amended to clarify that the line items listed in that paragraph can be disaggregated and should be disaggregated if doing so would provide relevant information
- IAS 1.114, which deals with the order of the notes to the financial statements, should be amended to clarify that the order shown in that paragraph is not a requirement, but is one that is commonly used
- adding wording to emphasise that an entity should consider the effect on both understandability and comparability when determining the order of the notes to the financial statements.

At the time of writing, it is expected that these tentative decisions will be reflected in an Exposure Draft of proposed amendments to IAS 1.

4. Alternative performance measures

This Section of the IFRS Top 20 Tracker considers the use of so-called ‘alternative performance measures’ in financial statements. An alternative performance measure is any numerical performance measure that is not defined in IFRS (eg ‘underlying earnings’). This could include items that are defined in IFRS but that the company measures and discloses in a different way (eg ‘revenue including share of joint ventures’).

Paragraphs 85–86 of IAS 1 ‘Presentation of Financial Statements’ include a requirement to present additional lines, headings and subtotals when such information is relevant to understanding an entity’s financial performance. Some entities apply this requirement in a way that results in the inclusion of alternative performance measures on the face of the statement of comprehensive income.

Regulators however have voiced concerns over the use of alternative performance measures, including some practices for including additional line items or subtotals. Regulators point out that, although IAS 1 permits some flexibility in presentation, it also includes various principles and more detailed requirements that are intended to limit the flexibility, including an overall requirement for a fair presentation. Additional line items are included only if they assist users in understanding the financial performance achieved and in making projections of future financial performance. Areas of concern include:

- the use of alternative performance measures that are not defined or for which the basis of calculation is unclear
- inconsistent use, or inconsistent calculations, of alternative performance measures from one period to the next
- presenting multiple subtotals that are not necessary or that are meaningless
- excluding the effects of certain transactions that management consider to be non-recurring or exceptional in some way from a subtotal that would ordinarily include that item (noting that the presentation of ‘extraordinary items’ is prohibited under IAS 1)
- not providing sufficiently clear or descriptive labels for the subtotals
- not explaining why an additional item, heading or subtotal is presented.

Readers should be aware that the IASB is monitoring these concerns and may act to address them in the future. Initial indications are that the IASB is likely to emphasise that where an entity presents or discloses aggregated items in subtotals and totals, those subtotals or totals must be fairly presented. More specifically, it is possible that the IASB will look to specify that the totals and subtotals should:

- be made up of items recognised or otherwise disclosed in compliance with IFRS
- be presented and labelled in a manner that makes what constitutes the subtotal understandable
- be calculated on a consistent basis from period to period
- not be displayed with more prominence than the specific subtotals referred to in IAS 1.

In addition, the European Securities and Markets Authority (ESMA) is currently consulting on proposed guidelines for the use of alternative performance measures by EU listed entities. While we await clarification from the IASB and ESMA, our view is that it is permissible to disclose subtotals such as Earnings Before Interest, Tax, Depreciation and Amortisation (EBITDA) on the face of an IFRS income statement but only if the subtotal is consistent with the requirement that an IFRS income statement should be relevant to, and of assistance in, explaining financial performance.

Some subtotals, such as 'gross profit' and 'profit before tax' are widely used and are clearly understandable. Other subtotals, including EBITDA, can also be relevant and helpful but only if used in a clear way that does not have the potential to confuse or mislead. Subtotals that are inherently misleading (or potentially so) should however be avoided. Examples of inappropriate subtotals include 'maintainable earnings', 'core earnings', 'underlying earnings', 'business performance' and 'earnings before volatility'. These are potentially misleading because they suggest that any income and expenditure excluded from the subtotal is not likely to recur or is less relevant to understanding the 'true' performance of the business. Any such suggestion is highly subjective and may not be borne out by future events.

In relation to whether it is permissible to disclose an 'operating profit' subtotal on the face of an IFRS income statement, we again believe that this or a similar subtotal (eg 'results from operations') is permissible. However, the points mentioned above are equally applicable here. In particular, the amount disclosed as operating profit must include all income and expenses that are operating in nature; expenses should not be excluded from operating profit solely on the grounds that they are unusual, infrequent or insignificant.

Net debt reconciliations

In last year's IFRS Top 20 Tracker, we featured an item on net debt reconciliations. 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.

As we reported last year, 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.

The IASB has heeded the Financial Reporting Lab findings and in June 2013 IASB Chairman, Hans Hoogervorst announced the IASB's intention to add a net-debt reconciliation requirement as part of a ten-point plan designed to make disclosures more effective. 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.

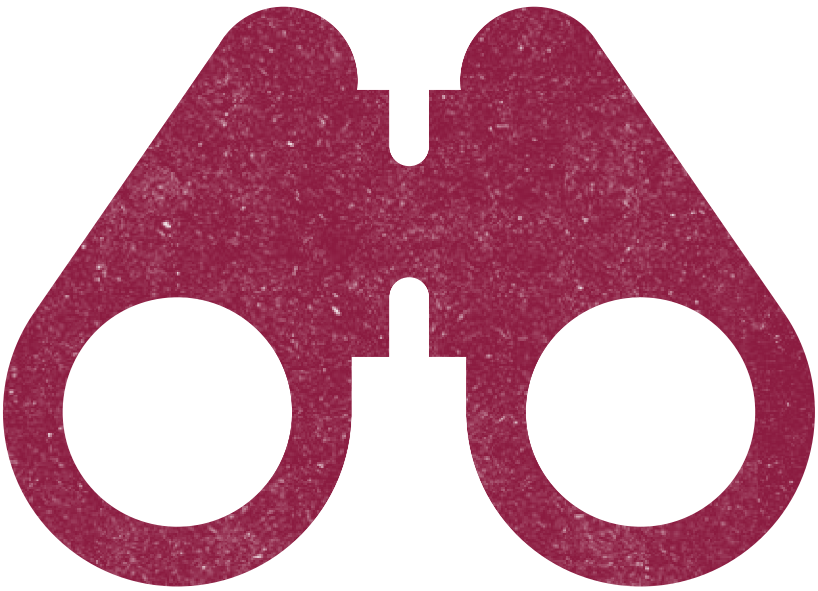
In summary, the reconciliations can provide insight on:

- 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	Examples
• **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



Areas of regulatory focus

5. Going concern

Going concern status

Although an economic recovery is underway in much of the world, economic conditions remain difficult in certain industries and countries, and many businesses face challenges in obtaining debt financing. Accordingly management's going concern assessment, and the related disclosures, continues to be a hot topic.

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.

A number of individual jurisdictions have reacted to the financial crisis of a few years ago by issuing their own guidance on how to disclose going concern uncertainties in an appropriate manner. In the UK for example, the Financial Reporting Council (FRC) 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.

While the guidance was produced with the UK in mind, it may nevertheless 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.

Disclosure requirements about the assessment of going concern are a topic of much international debate. In the UK, the Sharman Panel of Inquiry was commissioned to identify lessons from the financial crisis and recessionary environment for companies and auditors regarding going concern and liquidity risks and to recommend measures necessary to improve the existing reporting regime and related guidance in relation to these matters.

Among its recommendations was that an entity's going concern assessment should be integrated with management's business planning and risk management processes and:

- include a focus on both solvency and liquidity risks, whatever the business. In relation to solvency risks, this should include identifying risks to the entity's business model or capital adequacy that could threaten the entity's survival, over a period that has regard to the likely evolution of those risks given the current position in the economic cycle and the dynamics of the entity's own business cycles
- may be more qualitative and longer term in outlook in relation to solvency risk than to liquidity risk
- includes stress tests both in relation to solvency and liquidity risks that are undertaken with an appropriate level of prudence.

While the recommendations of this inquiry are specific to the UK, they will nevertheless be of wider interest to those entities who wish to be at the forefront of best practice in this area.

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 annual report 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.

Future developments

In 2012, the IFRS Interpretations Committee (IFRIC) considered a request regarding the going concern disclosures in IAS 1. As a result, it recommended a narrow-focus amendment to IAS 1 which would have provided guidance on how to identify material uncertainties and contain requirements about what to disclose about them.

When the IASB discussed the proposals in 2013 however, some IASB members were concerned about the sensitive nature of the disclosures that were being proposed while others were not persuaded that further guidance was needed. To date then, these proposals have not been developed. There is the possibility however that the IASB may return to this area, and readers should therefore monitor developments in this area.

6. 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 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. Despite being published in 2006, incorrect application of the Standard remains an issue and as a result continues to be the subject of regulatory scrutiny. This Section of the IFRS Top 20 Tracker considers some recurring areas of difficulty along with some recent developments that have taken place.

Chief operating decision maker

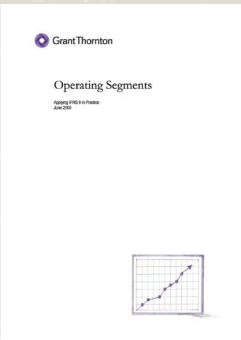
IFRS 8 requires segmental disclosures to be based on the internal information regularly used to assess financial performance and allocate resources between operating segments.

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 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 aggregation criteria set out in IFRS 8 enable 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 judgement, 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, and the specific amendment made to IFRS 8 by 'Annual Improvements to IFRSs 2011-2013 Cycle' (see box), it is essential 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.

Recent developments

In December 2013, the IASB published 'Annual Improvements to IFRSs 2011-2013 Cycle' containing a number of non-urgent, but necessary, minor amendments to IFRSs. Among the amendments were two relating to IFRS 8.

Aggregation of operating segments

The first amendment concerned the disclosure of additional information relating to the aggregation of operating segments. The specific improvement made by the IASB requires entities to disclose the judgements made in identifying their reportable segments when operating segments have been aggregated, including a brief description of the operating segments that have been aggregated and the economic indicators that determine the aggregation criteria.

Reconciliation of the total of the reportable segments' assets to the entity's assets

The second amendment clarifies that an entity is required to provide a reconciliation between the total reportable segments' assets and the entity's assets only if the segment assets are regularly reported to the chief operating decision maker.

Both of these improvements are effective for accounting periods commencing on or after 1 July 2014, although entities are permitted to apply them earlier.

Disclosures

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

The entity-wide disclosures (IFRS 8.32-34) 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.

Information about major customers

Regulators have noted incomplete or omitted information about major customers to be a common deficiency in preparing financial statements.

Readers are reminded that IFRS 8.34 states that if revenues from transactions with a single external customer amount to 10% or more of an entity's revenues, the entity shall disclose that fact, the total amount of revenues from each such customer, and the identity of the segment or segments reporting the revenues. The entity need not disclose the identity of a major customer or the amount of revenues that each segment reports from that customer however.

Restatement of previously reported information

IFRS 8.29 states that if an entity changes the structure of its internal organisation in a manner that causes the composition of its reportable segments to change, the corresponding information for previous periods should generally be restated.

Despite this requirement, failure to provide restated comparative period segment data following a change in reportable segments in financial statements has been noted as a common deficiency by some regulators.

Where an entity changes its internal organisation in a way that that results in a change in the identification of its reportable segments, this change should be reflected in the financial statements for the period in which the reorganisation occurs. If then a change in internal organisation occurs after the end of the reporting period but before the financial statements have been authorised for issue, an entity's reportable segments should not be amended to reflect the change.

7. Impairment assessments and disclosure

The guidance in IAS 36 'Impairment of Assets' is detailed, prescriptive and complex in some areas. Putting this guidance into practice also requires a significant degree of professional judgement. Against this background, financial statement users, regulators and accounting enforcement bodies continue to raise concerns about:

- the level of entities' impairment assessments
- the supportability of management's underlying assumptions
- the transparency and adequacy of the related disclosures.

Each is discussed in turn below.

Level of the impairment assessment

Individual asset level

The objective of IAS 36 is to ensure that an asset is carried at no more than its recoverable amount, which is the higher of the asset's value in use (VIU) and its fair value less cost of disposal (FVLCOD).

Where possible, the guidance in IAS 36 should be applied at the individual asset level. This will be possible only when:

- the asset generates cash inflows that are largely independent of those from other assets (or groups of assets) or
- the asset's VIU can be estimated to be close to FVLCOD which may be the case when the asset is no longer in use, or is soon to be replaced or abandoned.

Most assets generate cash inflows only in combination with other assets as part of a larger cash-generating unit (CGU) and therefore, it is not possible to calculate a recoverable amount for most individual assets that are held for continuing use. Management must therefore identify the CGU to which an asset belongs where impairment testing is required, but is not capable of being performed at an individual asset level.

> **Level of the impairment assessment**
> Executing the impairment assessment at the appropriate level is critical to ensuring that an over-performing asset or CGU does not mask an impairment of an under-performing asset or group of CGUs.

Goodwill

It is not possible to determine the recoverable amount of goodwill independently from other assets because goodwill does not generate cash flows on its own; rather it contributes to the cash flows of individual CGUs or multiple CGUs. As such, goodwill must be allocated to individual CGUs (or groups of CGUs) for the purpose of impairment testing.

The guidance in IAS 36 requires that goodwill acquired in a business combination is allocated to each of the acquirer's CGUs (or groups of CGUs) that are expected to benefit from the synergies of the combination. Further, the level to which the goodwill is allocated must:

- represent the lowest level within the entity at which the goodwill is monitored for internal management purposes and
- not be larger than an operating segment as defined by IFRS 8 'Operating Segments' (IFRS 8).

> **IAS 36 and IFRS 8 interaction**
> IFRS 8 permits operating segments to be aggregated together for purposes of reporting segment information when certain criteria are met; however, the allocation of goodwill to CGUs must not be at a higher level than the operating segments identified for segmental reporting under IFRS 8 (prior to applying the aggregation criteria).

Supportability of management's underlying assumptions when estimating VIU

It is an overarching principle of the VIU estimate that assumptions should be 'reasonable and supportable'. To do so, IAS 36 requires that:

- management consider whether the budget/forecast information (used as the basis for the cash flow estimates) reflects management's best estimate of the economic conditions that will exist over the remaining useful life of the asset
- management compare past projections with actual cash flows to ensure that the assumptions on which current projections are based are consistent with past actual outcomes.

Significant variances between budgeted (projected) and actual cash flow results may raise doubt whether assumptions are reasonable and supportable.

Supportability of management's underlying assumptions

A budget is of course a management tool and not simply a prediction about the future. A budget may therefore incorporate stretch targets or similar aspirational levels of financial performance. In using such a budget for VIU purposes, management should carefully consider whether these types of assumptions are reasonable and supportable in the context of IAS 36. IAS 36 also requires management to assess the reasonableness of its cash flow assumptions by examining the causes of differences between previous projections and actual outcomes.

Transparency and adequacy of related disclosures

When an entity recognises a material impairment loss for a CGU during the period, IAS 36 requires:

- general information about the events triggering the impairment loss for the CGU
- a description of the CGU in question
- where recoverable amount has been determined based on VIU, information about key assumptions on which management has based its cash flow projections and management's approach to determining the values assigned to each assumption.

The following table identifies some common criticisms by regulators when reviewing entity's financial statement disclosures and may be areas of focus for compliance in the future:

IAS 36 disclosure requirement	Criticism by regulators
Explanation of the events and circumstances that contributed to the impairment loss or reversal	• disclosures are too broad and do not provide entity-specific factors of the main events and circumstances that resulted in the impairment
Description of the entity's CGU when it recognises an impairment loss for the CGU during the period	• disclosures do not provide a description of the CGU and/or the description lacks substance and entity-specific information; therefore, financial statement users do not have sufficient context regarding the impact of the impairment on the overall activities and operations of the entity
Carrying amount of goodwill allocated to the unit (or group of units)	• disclosures not provided despite IAS 36.134(a)'s requirement to do so when the carrying amount of goodwill allocated to that unit (or group of units) is significant in comparison with the entity's total carrying amount of goodwill
Each key assumption on which management has based cash flow projections for the period	• disclosures do not always discuss key assumptions and, for those that do, many do not contain sufficient detail that would provide meaningful information to investors • key assumptions incorporate more than the discount rate and growth rate, consistent with Illustrative Example 9 in IAS 36 (eg expected gross margin, government bond rates, exchange rate for the period, raw material price inflation, market share, etc.) • comparative information is required and often not disclosed
Explanation of the basis of key assumptions and the valuation approach used to determine the recoverable amount	• disclosures do not make it clear if the values reflect past experience, or if they are consistent with external sources of information (and if not, how and why they differ)
Where goodwill or indefinite life intangibles have been allocated to a CGU (or group of CGUs), but no impairment has been recognised, reasonably possible changes in assumptions if such changes would cause the unit's carrying amount to exceed its recoverable amount	• disclosures do not always contain a sensitivity analysis and for those that do, there is a lack of consistency in the analyses provided • where equity book value exceeds market capitalisation, some regulators expect to see a transparent sensitivity analysis • sensitivity analyses should incorporate all key assumptions (beyond discount and growth rate)

8. Revenue recognition

Back to the basics

The revenue recognition policy is often the most important accounting policy in the financial statements and therefore continues to be a key area of focus and scrutiny for regulators.

Common (and recurring) criticisms from regulators when reviewing disclosures of revenue recognition accounting policies include:

- the use of boiler plate/generic wording (often straight from the Standards) which therefore lacks entity-specific considerations
- the disclosures are brief whereby the accounting policy is not set out in sufficient detail
- policies applied to various revenue streams (identified elsewhere in the report) are not addressed/described
- areas of significant judgement are not explained.

Given the inadequacy of some disclosure, regulators continue to ask management for additional information to understand the basis on which management has satisfied itself that:

- where services are rendered – the stage of completion of services rendered can be determined reliably
- where various revenue streams are identified elsewhere in the financial report, but not addressed in the footnotes – it has identified the significant policies applied to these revenue streams
- where revenue relates to both the sale of goods and rendering of services – the revenue has been allocated to the various components and recognised appropriately
- it has adequately disclosed and explained significant judgments and/or estimates.

Each is discussed in turn below.

Stage of completion where services rendered

IAS 18 ‘Revenue’ requires that where a company derives revenue from the rendering of services and the outcome of the transaction can be estimated reliably, revenue should be recognised by reference to the stage of completion of the transaction at the end of the reporting period.

IAS 18 prescribes that the method selected be appropriate to the company’s particular circumstances and be capable of reliably measuring the services performed.

Guidance note: Determining the stage of completion

Depending on the nature of the entity’s business and its particular transactions, one or more of the following methods to determine the stage of completion of a transaction may be appropriate:

- survey 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.

Whatever the method chosen, IAS 18.35(a) explicitly 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.

Policy disclosure for each category of revenue

IAS 18 requires disclosure of the amount 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 and
- dividends.

Where a category of revenue is considered to be material enough to be disclosed, an accounting policy for that category should also be disclosed. Depending on the complexity of the entity's business, it may need to disclose distinct policies for sub-categories of transactions (within each overall category identified) to provide users of the financial statements with meaningful information.

Multiple element arrangements

IAS 18 requires an entity to apply the revenue recognition criteria separately to each identifiable 'component' of a single transaction. For example, where the sales price of a product (eg entertainment system) includes on-going support and servicing, an amount is deferred and recognised as revenue over the period during which the service is performed. Failure to identify a component may result in inappropriate accounting for that particular item as the manner and timing of revenue recognition may differ.

Significant judgments or estimates

The existing revenue recognition guidance has been criticised for lacking guidance in critical areas (eg multiple element arrangements). Accordingly, when applying the revenue recognition guidance to these areas and other complex arrangements, management must apply judgement and make estimates. In such cases, management should disclose:

- judgements made in the process of applying the entity's revenue recognition policies that have the most significant impact on the amounts recognised in the financial statements (IAS 1.122)
- information about assumptions made about the future and other major sources of estimation uncertainty that have a significant risk of resulting in material adjustment within the next financial year (IAS 1.125)
- any other accounting policies used that are relevant to an understanding of the financial statements (IAS 1.117(b)).

Types of revenue recognition issues that would be expected to require significant judgments or estimates (and therefore necessitate disclosure of specific accounting policies) may include:

- the combination of separate contracts or the segmentation of individual contracts
- multiple-element arrangements
- application of the percentage of completion method
- assignment of rights for a fixed fee or non-refundable guarantee
- bill and hold sales
- consignment sales
- agency agreements
- real estate sales.

9. 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. As the financial crisis of a few years ago showed, the significance of a company's ability 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.

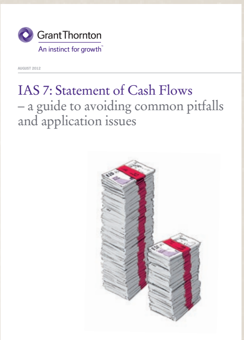
The importance of the statement of cash flows being properly prepared is apparent from recent actions taken by regulators. Companies that appear to take less care over the presentation of their statement of cash flows and supporting notes than they take over the other primary statements have been challenged.

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 paying particular attention to the incorrect classification of cash flows, with the Canadian Securities Administrators specifically referring to inadequate classification of cash flows between operating, investing or financing activities in its 2013 review of companies' disclosures. This shows the need 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.

Operating cash flows

A recent report by the UK's Financial Reporting Lab has found that investors want to better understand the link between cash generated, profit and loss and the statement of financial position when entities use the indirect method of presenting the statement of cash flows. In particular

- investors want the reconciliation of profit or loss to operating cash flows to be at the top of the statement of cash flows and not in the notes (by way of background, IAS 1 is not explicit as to whether the adjustments to profit or loss should be presented on the face of the statement of cash flows or in the notes)
- companies should start the statement of cash flows with operating profit or loss. If they start with another figure it should be reconciled first to a subtotal for operating profit or loss
- investors prefer disclosures that show separately changes in the individual components of working capital, and other differences between operating profit or loss and operating cash flows that are specific to the business. Companies should use descriptions that link easily to relevant items on the statement of financial position and explain the nature of the differences that convert profits to cash.

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.

Cash flows that arise in a foreign currency 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.

If 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.

Complex areas of accounting

10. Income taxes

Introduction

This Section looks at some key issues relating to the application of IAS 12 'Income Taxes' which, being a complex Standard, continues to be the subject of comments by regulators.

Where is tax recognised?

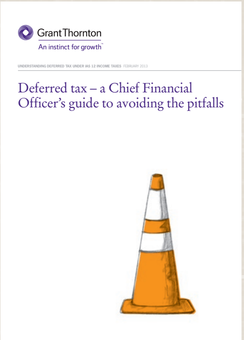
IAS 12 requires current and deferred tax to be recognised outside profit or loss if it relates to items that are recognised outside profit or loss, whether or not in the same reporting period.

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 whose reconciliation of profit before tax multiplied by the applicable tax rate(s) to the actual tax charge is unclear or appears inaccurate (for example showing deferred tax movements 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 when 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.

Other taxes

The scope of IAS 12 is limited to income taxes. These are defined in IAS 12.2 as follows:

"For the purposes of this Standard, income taxes include all domestic and foreign taxes which are based on taxable profits. Income taxes also include taxes, such as withholding taxes, which are payable by a subsidiary, associate or joint arrangement on distributions to the reporting entity."

As a result, if taxes are not based on 'taxable profits', they are not within the scope of IAS 12. Following the publication of IFRIC 21 'Levies', a number of non-income taxes that fall outside the scope of IAS 12 may fall within the scope of IFRIC 21. For further information, please refer to Section 17.

11. Share-based payment arrangements

Share-based payment arrangements

Share-based payments such as share option schemes continue to be a popular way for entities 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 arrangements are set out in IFRS 2 'Share-based Payment' (IFRS 2). 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. Those conditions can be vesting or non-vesting.

Vesting conditions are the conditions which determine whether the entity receives the services that entitle the counterparty to receive the award. Vesting conditions can be:

- service conditions, which require the counterparty to complete a specified period
- performance conditions, which require the counterparty to meet certain performance targets in addition to completing a period of service (ie a service condition). Performance conditions might include a market condition (a condition which is related to the market price of the entity's equity instruments).

Vesting conditions, except market conditions, should not be taken into account when estimating the fair value of the equity instruments granted.

A share-based payment may also include so-called non-vesting conditions. This terminology is somewhat confusing in that these conditions still need to be met in order for the counterparty to receive the share or options (ie for the awards to vest). However, unlike vesting conditions, non-vesting conditions do not relate to service or performance. As is the case for a market condition, IFRS 2 requires non-vesting conditions to be taken into account when measuring the fair value of an award at grant date.

Recent developments

Annual Improvements to IFRSs 2010-2012 Cycle, effective prospectively for annual periods beginning on or after 1 July 2014, amended IFRS 2 in order to clarify:

- the definition of vesting conditions by defining a performance condition and a service condition
- that a market condition can be based on the market price (or value) of the entity's equity instruments or the equity instruments of another entity in the same group
- that a market condition is a performance condition
- that a share market index is a non-vesting condition because it not only reflects the performance of the entity, but also of other entities outside the group.

Impact on selecting a valuation model

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

Other approaches 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

Entities 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. In this situation, management may decide to modify the terms of the arrangement, and this will have accounting consequences.

IFRS 2 requires an entity to take into account a modification which is beneficial to the employee. A typical example would be reducing the exercise price of an option which will increase its fair value. In such situations, the entity should calculate the incremental fair value, which 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. This incremental value is recognised as an expense over the reminder of the original vesting period (if any).

On the other hand, the entity should ignore a modification which is not beneficial to the employee. That is to say, it should continue to account for the award as if the modification had not occurred. This is in order to prevent abuse of the Standard.

Cancellations and replacement awards

Where a share-based payment award is cancelled by either the entity or the counterparty, the entity is required to recognise immediately the amount that otherwise would have been recognised over the remainder of the vesting period.

If, however, the entity grants a new award and, on the grant date, it identifies the new award 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 entity, 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. 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 its 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 entity which has granted awards to employees of a subsidiary, the debit entry in its separate financial statements is usually made to the cost of investment in the subsidiary.

Intermediate parent entities

In some situations the parent entity 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 entity settling the award recognises an investment in the subsidiary even though it does not own shares in that subsidiary.

The alternative treatment is that the entity 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 the subsidiary. Where there are a number of intermediate parent entities 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. Business combinations

IFRS 3 Revised

For most entities mergers and acquisitions are infrequent but, when they happen, these transactions are significant, complex and each is unique. The accounting for these activities is addressed by IFRS 3 'Business Combinations', a Standard that continues to throw up a number of practical issues and challenges. This Section of the IFRS Top 20 Tracker discusses the areas in IFRS 3 which either cause practical problems in the application of the requirements or that are often overlooked.

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.

Recent developments: Clarifying the interrelationship of IFRS 3 and IAS 40 when classifying property as investment property or owner-occupied property

In December 2013, the IASB published 'Annual Improvements to IFRSs 2011-2013 Cycle' containing a number of non-urgent, but necessary, minor amendments to IFRSs. One of the more significant amendments made was one clarifying that IFRS 3 and IAS 40 'Investment Property' are not mutually exclusive. The IASB has therefore stated that in determining whether:

- a property is owner-occupied property or investment property, judgement should be exercised based on the requirements of IAS 40.7-14
- the acquisition of an investment property meets the definition of a business combination or is the acquisition of an asset, reference should be made to IFRS 3's definition of a business (not to IAS 40.7-14).

Depending on how IFRS 3 and IAS 40 have been interpreted in the past, this could lead to changes in practice in the accounting for acquisitions of investment properties.

The amendments to IAS 40 are to be applied prospectively. An entity may however choose to apply the amendment to individual transactions that occurred prior to the beginning of the first annual period occurring on or after the effective date, but only where the information needed is available to the entity.

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.

Even if the acquirer is not intending to use an intangible asset acquired in a business combination (for example an acquired brand name which is to be discontinued) it is still required to recognise the asset at its 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, the share price at the acquisition date must be 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 can lead to surprises in practice because the consideration transferred for accounting purposes may be higher (or lower) 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 that will be paid only on the occurrence (or non-occurrence) of a specified future event, or an amount that varies dependent on the extent to which the acquiree meets a specified target(s) such as a future profit metric. IFRS 3 refers to this as contingent consideration and requires it to be included, at fair value, in the consideration transferred at the acquisition date.

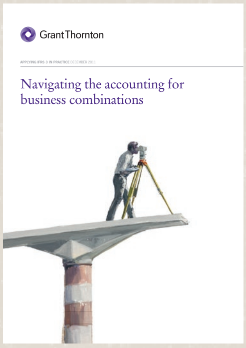
Where contingent consideration gives rise to a financial asset or liability within the scope of IAS 39 'Financial Instruments: Recognition and Measurement', changes in fair value after the acquisition are recognised in profit or loss in accordance with IAS 39. Where contingent consideration meets the 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 IFRS Interpretations Committee (IFRIC) was asked to consider this issue, and in January 2013 issued an agenda decision that an arrangement in which contingent payments are automatically forfeited if employment terminates should lead to a conclusion that the arrangement is remuneration for post-combination services rather than part of the consideration for the acquisition, unless the arrangement is not substantive.

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



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.

13. Hedge accounting

Note: This Section is based on the existing hedge accounting requirements of IAS 39 'Financial Instruments: Recognition and Measurement'. As discussed in Section 19, the IASB has published new hedge accounting requirements as part of IFRS 9 'Financial Instruments' which can be adopted early provided that all of the other (existing) requirements of IFRS 9 have been applied or are applied at the same time.

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.

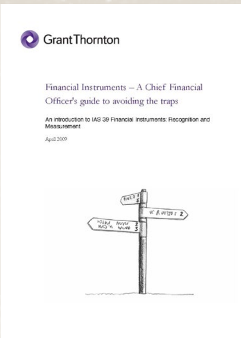
Many companies choose to manage these risks by identifying and monitoring exposures and developing hedging strategies to mitigate risks to acceptable levels. Often these strategies involve the use of derivatives, for example interest rate swaps are used to mitigate interest rate risk, although the use 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 changes 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'**.

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

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 a fair value hedge is the use of an interest rate swap (IRS) to offset changes in the fair of a fixed rate loan or debt asset due to changes in interest rates. An entity that holds a fixed interest rate loan asset could take out a fixed-to-variable interest rate swap to hedge this exposure, such that it is paying a variable rate of interest in aggregate.

Fair value hedge accounting departs from the normal measurement rules for the hedged item – in this example the fixed rate loan. When hedge accounting applies 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 (wholly or partly) 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 due to changes in exchange rates on a foreign currency sale that is committed or highly probable.

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 previously 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.

Balance sheet

	In	Out	In	Out
Figure 1	11,458	7,829	4,653	2,789
Figure 2	2,789		9,111	
Figure 3	1,358	7,352	856	2,789
	15,632		**14,620**	
Figure 4			3,598	6,212
Figure 5			7,448	9,567
Figure 6			2,479	9,112
Figure 7			231	991
Figure 8			4,453	4,591
Figure 9			8,999	19,123
			27,208	**49,596**
Figure 10	1,546	1,059		
Figure 11	3,385	1,890		
	4,931	**2,949**		
Figure 12	7,516			8,909
Figure 13	1,029			2,158
Figure 14	4,809			3,991
Figure 15	6,380			6,824
Figure 16	5,978			8,773
	25,712			**30,655**

Effective for the first time

14. Consolidation package

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'.

The consolidations Standards are 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. With the exception of IFRS 12, which can be applied independently of the other Standards, early application is only possible if all of the Standards in the consolidation package are also adopted at the same time.

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 10, 11 and 12 are covered briefly below.

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

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 box).

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.

IFRS 11 'Joint Arrangements'

IFRS 11 aims to improve on the Standard it replaces, IAS 31 'Interests in Joint Ventures', by establishing principles for accounting for joint arrangements (an arrangement over which two or more parties have joint control) that focus more on the nature of the investors' rights and obligations and less on the legal form.

IFRS 11 replaces IAS 31's three categories of 'jointly controlled entities', 'jointly controlled operations' and 'jointly controlled assets' with two new categories – 'joint operations' and 'joint ventures'.

- a joint operation is a joint arrangement whereby the parties that have joint control of the arrangement (ie joint operators) have rights to the assets, and obligations for the liabilities, relating to the arrangement.
- a joint venture is a joint arrangement whereby the parties that have joint control of the arrangement (ie joint venturers) have rights to the net assets of the arrangement.

Entities that have previously been classified as jointly controlled entities under IAS 31 (ie joint ventures that were structured through a separate legal entity) will often be classified as 'joint ventures' under IFRS 11.

In limited circumstances a jointly controlled entity under IAS 31 will however be classified and accounted for as a 'joint operation' – broadly when the venturers have rights and exposure to the underlying assets and liabilities. This determination requires an assessment of the legal form of the vehicle, other contractual arrangements and other facts and circumstances (such as whether the activities of the arrangement are primarily designed for the provision of output to the parties). Arrangements previously categorised as jointly controlled operations and jointly controlled assets in accordance with IAS 31 will also fall into the joint operation category in accordance with IFRS 11.

Emerging issues – 'other facts and circumstances'

At the time of writing, the IFRS Interpretations Committee (IFRIC) is considering a number of requests to clarify how the assessment of 'other facts and circumstances' affects the classification of a joint arrangement as a joint operation or a joint venture. These include:

- whether an assessment of 'other facts and circumstances' should take into account facts and circumstances that do not involve contractual and (legal) enforceable terms
- does the fact that the output from the joint arrangement is sold at a market price prevent the joint arrangement from being classified as a joint operation, when assessing 'other facts and circumstances'?
- does financing from a third party prevent an arrangement from being classified as a joint operation?
- does the nature of the output produced by the joint arrangement determine the classification of a joint arrangement when assessing 'other facts and circumstances'?
- when assessing 'other facts and circumstances' in the case in which parties are taking substantially all of the output, is the assessment based on volumes or monetary values?

Readers who may be affected by these issues should monitor closely the outcome of IFRIC's decisions.

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.

The Standard establishes disclosure objectives according to which an entity discloses:

- significant judgements and assumptions (and changes) made by the reporting entity in determining whether it controls another entity
- the interest that the non-controlling interests have in the group's activities
- the effect of restrictions on the reporting entity's ability to access and use assets or settle liabilities of consolidated entities
- the nature of, and changes in, the risks associated with the reporting entity's interests in consolidated structured entities, joint arrangements, associates and unconsolidated structured entities.

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.

15. IFRS 13 'Fair Value Measurement'

IFRS 13 'Fair Value Measurement' became effective for accounting periods beginning on or after 1 January 2013. The Standard:
- explains how to measure fair value by providing a new definition and introducing a single set of requirements for (almost) all fair value measurements
- clarifies how to measure fair value when a market becomes less active
- improves transparency through additional disclosures.

The requirements of IFRS 13 are to be applied prospectively as of the beginning of the annual period in which it is initially applied.

The scope of the Standard

IFRS 13 applies to both financial and non-financial items but does not itself specify which items must be measured at fair value.

Instead it applies when another IFRS requires or permits fair value measurements – either in the primary statements themselves or in the footnotes (including 'fair value-based' measurements). In other words it explains how to measure fair value rather than when to.

At first glance it may look like the Standard will not affect many entities. The reality however is that fair value measurements are much more prevalent in IFRS than may at first be appreciated.

As well as the more obvious examples such as IAS 39 'Financial Instruments: Recognition and Measurement' and IAS 40 'Investment Property', significant fair value measurement requirements are also to be found in Standards such as IFRS 3 'Business Combinations', IAS 16 'Property, Plant and Equipment' and IAS 36 'Impairment of Assets' to name just a few. In addition to items measured at fair value in the primary statements, IFRS 13 also applies to items that are fair valued for disclosure purposes only.

The definition of fair value

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 (ie an exit price).

The Standard 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.

Fair value hierarchy

IFRS 13 establishes a fair value hierarchy under which the inputs to valuation techniques used to measure fair value are categorised into three levels. This requirement, which had previously applied only to financial instruments, is aimed at increasing consistency and comparability when measuring fair value and making related disclosures. The three levels of the hierarchy are as follows:
- Level 1 inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date
- Level 2 inputs are inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly
- Level 3 inputs are unobservable inputs for the asset or liability.

Disclosures

IFRS 13 introduces a comprehensive disclosure framework for fair value measurements, extending the use of the fair value disclosures required by IFRS 7 'Financial Instruments: Disclosures' to non-financial items measured at fair value, and requiring disclosures about the fair value of certain items not measured at fair value.

This framework is intended to help users of financial statements assess the valuation techniques and inputs used to develop those measurements. The disclosures required are affected by the fair value hierarchy discussed above, with increased disclosure requirements applying to the lower levels of that hierarchy.

These requirements will result in significant amounts of additional disclosure for some companies, for example where investment property is measured at fair value.

Impact

As discussed above, the scope of IFRS 13 is wide. Fair value is a pervasive concept within IFRS but most reported assets and liabilities do not have quoted prices. As a result fair value needs to be estimated in many situations.

This does not necessarily mean that IFRS 13 will actually change fair values significantly though. Indeed in many cases it will not, as much of the new guidance is intended to be consistent with common valuation practices. However, its impact will ultimately depend on the items being fair valued and the techniques currently used. Even entities largely unaffected by the valuation guidance are likely to be affected by IFRS 13's extensive disclosure requirements.

Areas of regulatory focus

As with any new Standard, we expect regulators to pay close attention to the way that entities under their supervision are implementing IFRS 13. In addition, a number of regulators have indicated that they will focus on the following specific issues:

The characteristics of the asset or liability

Under IFRS 13, characteristics of an asset or liability are taken into account in fair value estimates if:

a. they are a characteristic of the asset or liability in question (rather than a characteristic of the entity that holds the item)
b. they would influence market participants' pricing decisions.

The Standard indicates that this will result in some cases in an adjustment being made to observable market inputs (eg a control premium when measuring the fair value of a controlling interest) but only when this is consistent with the unit of account. Questions have however been raised as to what is the appropriate unit of account in certain scenarios, and the IASB is currently discussing this matter. Pending clarification of this matter by the IASB, regulators have indicated that they expect issuers to disclose clearly their analysis regarding the unit of account.

Non-performance risk

IFRS 13 requires that the fair value of a liability should reflect the effect of non-performance risk. This includes, but is not limited to, an entity's own credit risk. This is particularly relevant to entities that have entered into derivative transactions or have designated financial liabilities to be measured at fair value in accordance with IAS 39's fair value option. For financial liabilities measured at fair value, including derivative financial liabilities, fair value estimates should incorporate the effect of and changes in the entity's own credit risk. This generally involves incorporating an adjustment into the valuation known as a debit valuation adjustment (or DVA).

There should also be proper recognition of counterparty credit risk when determining the fair value of financial instruments and providing relevant disclosures. This generally requires making a credit valuation adjustment (or CVA).

Regulators have noted that they expect issuers to provide an appropriate level of transparency on the methodologies used, and when the amounts are significant, on the effects of counterparty credit risk on measurement of the fair value of assets and non-performance risk on the measurement of the fair value of liabilities.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IFRS 13 Fair Value Measurement

For more information on IFRS 13's fair value measurement, please refer to our Special Edition of IFRS News '**IFRS 13 Fair value measurement**' which can be obtained from your local IFRS 13 contact.

16. Accounting for pension costs

Next on our list of IFRS Top 20 Tracker items is the accounting for pension costs. While the accounting for costs arising from defined contribution schemes is relatively straightforward, the accounting for costs relating to defined benefit pension schemes is a perennial area of difficulty which has seen a number of recent developments.

We discuss these developments below. Before doing so however, we recap briefly on the requirements of IAS 19 'Employee Benefits (Revised 2011)'.

IAS 19 'Employee Benefits' (Revised 2011)

IAS 19 (Revised 2011) which became effective for periods ending on or after 1 January 2013, changes the way defined benefit pension schemes are accounted for.

The amended version is intended to improve the recognition, presentation, and disclosure of defined benefit plans. It will have a particular impact on the amounts presented in profit or loss and other comprehensive income (OCI).

Major changes

The major changes made in the amended version of the Standard will result in:

- immediate recognition of all estimated changes in the cost of providing defined benefits and all changes in the value of plan assets. The various methods which allowed deferral of some of those gains or losses under the previous version of IAS 19, including the 'corridor' method, have been eliminated
- a new presentation approach that distinguishes the different types of gains and losses arising from defined benefit plans and requires that all gains and losses are presented in profit or loss apart from 'remeasurements' that are presented in OCI . The table sets out the changes in benefit costs which are to be presented separately under the new approach.

IAS 19 'Employee Benefits' (Revised 2011)

Type of gain or loss	Recognition
service cost	in profit or loss
net interest on the net defined benefit liability or asset	in profit or loss
remeasurement of the defined benefit liability or asset	in other comprehensive income*

* Note that the previous IAS 19 option for entities to recognise in profit or loss all changes in defined benefit obligations and in the fair value of plan assets is eliminated.

In addition to the changes mentioned above, 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 possibility of many companies seeing a reduction in profits as a result.

Recent developments

Discounting of defined benefit pension plans

Because of the long-term nature of pension obligations, the accounting for defined benefit pension plans is highly sensitive to the discount rate used. In recent months, the IFRS Interpretations Committee (IFRIC) has considered a number of issues in relation to the application of IAS 19 (Revised 2011)'s requirements on the discount rate and has issued some important agenda rejection decisions (often referred to as rejection notes). Although IFRIC rejection notes are not officially part of IFRS, they are nonetheless an important source of guidance for companies, and regulators. There is an expectation on the part of stakeholders in IFRS that IFRIC rejection notes will be carefully considered by preparers in determining their accounting policies.

Pre-tax or post-tax rate?

In July 2013, IFRIC issued a rejection note on the determination of the rate to be used to discount post-employment benefit obligations. IFRIC had been approached for guidance on whether a pre-tax or post-tax rate should be used. In response, IFRIC issued a rejection note expressing their observation that the discount rate used to calculate a defined benefit obligation should be a pre-tax discount rate.

Actuarial assumptions: discount rate

A few months later, IFRIC also issued a rejection note relating to the use of the discount rate and actuarial assumptions under IAS 19 (Revised 2011).

The background to this rejection note relates to the requirement in IAS 19 (Revised 2011) that the rate used to discount post-employment defined benefit obligations should reflect market yields on high quality corporate bonds.

The request for guidance noted that according to prevailing past practice, listed corporate bonds have usually been considered to be high quality corporate bonds if they receive one of the two highest ratings given by a recognised rating agency (eg 'AAA' and 'AA'). The request for guidance also noted that because of the financial crisis, the number of corporate bonds rated 'AAA' or 'AA' had decreased in proportions that the submitter of the request considered to be significant. In light of this, the submitter asked IFRIC whether corporate bonds with a rating lower than 'AA' can be considered to be high quality corporate bonds.

In response IFRIC noted that the expression 'high quality' as used in IAS 19 (Revised 2011), reflects an absolute concept of credit quality and not a concept of credit quality that is relative to a given population of corporate bonds.

Consequently, in November 2013, IFRIC issued a rejection note which expressed their observation that the concept of high quality should not change over time. Accordingly, a reduction in the number of high quality corporate bonds should not result in a change to the concept of high quality and IFRIC therefore does not expect that an entity's methods and techniques used for determining the discount rate so as to reflect the yields on high quality corporate bonds will change significantly from period to period.

IFRIC also noted that the discount rate will typically be a significant actuarial assumption and that it may also be relevant to the disclosure requirements in IAS 1 'Presentation of Financial Statements' relating to significant judgements exercised in the preparation of the financial statements.

Regional market issue

A similar issue has been raised in relation to the discount rate used in specific regions of the world.

As noted above, 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. IAS 19 (Revised 2011) also states that in countries where there is no deep market in such bonds, market yields on government bonds shall be used.

Difficult economic conditions in some European countries within the Eurozone have 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.

IFRIC considered the issue and have expressed support for the view that for a liability expressed in Euros, 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. In view of the significance of the matter, IFRIC has recommended the IASB to address it.

Accordingly the IASB has included a proposal in its 'Annual Improvements to IFRSs 2012-2014 Cycle' that would clarify that the high quality corporate bonds used to estimate the discount rate for post-employment benefit obligations should be denominated in the same currency as the liability. Consequently, the IASB proposes to clarify that the depth of the market for high quality corporate bonds should be assessed at the currency level.

Clarification of treatment of employee contributions

Prior to the publication of IAS 19 (Revised 2011), it was common practice for entities to deduct employee contributions to defined benefit plans from service cost in the period in which the service was rendered. IAS 19 (Revised 2011) however requires contributions that are linked to service to be attributed to periods of service as a reduction of service cost (ie as a negative benefit).

Concerns were raised about the complexity of this requirement when it was applied to simple contributory plans. In November 2013, the IASB therefore published narrow scope amendments to IAS 19 entitled 'Defined Benefit Plans: Employee Contributions (Amendments to IAS 19)'. The Amendments:

Amendment	Description
• **clarify the requirements that relate to how contributions from employees or third parties that are linked to service should be attributed to periods of service**	– the IASB has clarified that if the amount of the contributions from employees or third parties is dependent on the number of years of service, then an entity shall attribute the contributions to periods of service using the same attribution method required by IAS 19.70 for the gross benefit (ie either using the plan's contribution formula or on a straight-line basis)
• **permit a practical expedient if the amount of the contributions is independent of the number of years of service**	– the practical expedient allows an entity to recognise such contributions as a reduction in the service cost in the period in which the related service is rendered, instead of attributing the contributions to the periods of service

On the horizon

17. IFRIC 21 'Levies'

IFRIC 21 'Levies' considers how an entity should account for liabilities to pay levies imposed by governments. A number of new levies were raised following the global financial crisis, particularly on banks. However, IFRIC 21 also applies to several more established types of non-income tax: for example certain property, environmental and payroll taxes (excluding social security contributions or similar taxes within the scope of IAS 19 'Employee Benefits'). As levies are not based on taxable profits, they fall outside the scope of IAS 12 'Income Taxes'. The related liability is therefore accounted for under IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'.

IFRIC 21 addresses the accounting for a liability to pay a levy that is within the scope of IAS 37, in particular when an entity should recognise a liability to pay a levy. It also addresses the accounting for a liability to pay a levy whose timing and amount is certain.

Under IFRIC 21, the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. For example, if the activity that triggers the payment of the levy is the generation of revenue in the current period and the calculation of that levy is based on the revenue that was generated in a previous period, the obligating event for that levy is the generation of revenue in the current period. Where the activity that triggers the payment of the levy occurs over a period of time, the liability to pay a levy is recognised progressively. For example, if the obligating event is the generation of revenue over a period of time, the corresponding liability is recognised as the entity generates that revenue.

IFRIC 21 also clarifies that an entity does not have a constructive obligation to pay a levy that will be triggered by operating in a future period as a result of the entity being economically compelled to continue to operate in that future period. This can lead to accounting outcomes that some find counter-intuitive for levies that are measured by reference to current period activities but are triggered only if the entity continues to operate on a specified date in a future period.

Snapshot

IFRIC 21 clarifies that the obligating event that gives rise to a liability to pay a levy is the activity that triggers the payment of the levy, as identified by the legislation. If this 'activity' arises on a specific date within an accounting period then the entire annual obligation (and the related expense or debit) is recognised on that date.

This single date recognition approach would represent a change from past practice for many non-income taxes across a number of jurisdictions. This is leading to questions as to whether particular non-income taxes are within the scope of IFRIC 21.

Effective date

IFRS 21 is effective for annual periods beginning on or after 1 January 2014. Earlier application is permitted. It is to be applied retrospectively.

Issues

Property taxes

In many countries property taxes are levied by municipalities or other local government bodies on the owner of a property on a specific date. Notwithstanding the strict timing of the legal obligation, in practice many entities have up till now spread the expense over the annual period (and recorded accruals or prepayments as necessary to effect this).

Accordingly it appears that many property taxes will fall within the scope of IFRIC 21. This may affect the timing of expense recognition for entities whose previous policy was to spread the expense over the annual period.

Payroll-based taxes

For taxes based on payroll costs or similar, a question arises as to whether IFRIC 21 or IAS 19 applies. IAS 19 applies to 'social security contributions', but this term is not defined.

In cases where the entity's obligation is simply a percentage of wages and salaries the issue of whether such taxes fall within the scope of IFRIC 21 makes little or no practical difference. It may however be relevant to more complex situations such as payroll taxes that are subject to a threshold, for example where a payroll tax is calculated on the basis of wages paid or payable by the entity in a financial year if wages exceed a minimum annual amount.

Taxes payable under the terms of a licence

In some countries or sectors, entities are required to pay an annual fee to a regulator as a condition for holding a licence to operate in a particular market or undertake a particular activity (eg a telecom service licence). The fee is sometimes designed to allow the regulator to recoup a portion of its annual operating costs from the entities it regulates.

As an operating licence represents a right to operate in a particular market, it might be considered that a fee payable as a condition of continuing to hold a licence is therefore no different to a levy for participation in a specific market (eg a bank levy). Accordingly it could then be considered that such fees fall within the scope of IFRIC 21.

Conclusion

IFRIC 21 will apply to many different types of levy and non-income tax. That said, it is expected to change current practice mainly in cases when the relevant legislation identifies a trigger date in a future accounting period but the amount payable is based on current period activity.

18. Investment entities

In 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.

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.

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.

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.

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 • if the consolidation exception applies to all an investment entity's subsidiaries throughout the current and all comparative periods (ie it has no services subsidiaries), its separate financial statements are its only financial statements.

Emerging issues – accounting for an investment entity subsidiary that also provides investment-related services

As noted in the table, an investment entity measures its investments in subsidiaries, including subsidiaries that are investment entities, at fair value, rather than consolidating those subsidiaries, unless the subsidiary provides investment-related services. If a subsidiary provides investment-related services however, the investment entity consolidates the subsidiary. A question was raised though over the accounting to be applied where an investment entity's subsidiary is itself an investment entity (and has investees measured at fair value) and, additionally, provides investment-related services.

The IFRS Interpretations Committee (IFRIC) considered this question in their January 2014 meeting, acknowledging that IFRS 10 does not give guidance on the accounting by an investment entity parent for an investment entity subsidiary when that subsidiary also provides investment-related services to third parties. IFRIC's tentative conclusion was that an investment entity parent should account for all investment entity subsidiaries in the same way, ie at fair value. Consequently, IFRIC has proposed that this accounting should be made clear through the IASB's Annual Improvements process.

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.

19. IFRS 9 'Financial Instruments'

IFRS 9 'Financial Instruments' is a multi-phase project that will eventually replace IAS 39 'Financial Instruments' in its entirety. The first phase was published in November 2009 in reaction to the financial crisis and the overall project is finally nearing completion (with the exception of macro-hedge accounting, a specialised topic that is mainly of interest to the banking sector). This Section of the IFRS Top 20 Tracker considers changes that were made to the Standard in late 2013 together with changes that are expected to be made in the first half of 2014.

Amendments made to the Standard in the last year

Hedge accounting

In November 2013, the IASB published Chapter 6 of IFRS 9 'Hedge Accounting'.

IAS 39's hedge accounting requirements had been heavily criticised for containing complex rules which either made it impossible for entities to use hedge accounting or, in some cases, simply put them off doing so. As an example, hedge effectiveness was judged on both a prospective and a retrospective basis, with a 'bright-line' quantitative range of 80-125% being used to assess retrospective effectiveness on a quantitative basis. Anything outside this range resulted in the discontinuance of hedge accounting, leading to profit and loss volatility.

In part this complexity was a reflection of the fact that the hedge accounting requirements were an exception to IAS 39's normal requirements. There was however also a perception that hedge accounting did not properly reflect entities' actual risk management activities, thereby reducing the usefulness of their financial statements. IFRS 9's new requirements look to rectify some of these problems, aligning hedge accounting more closely with entities' risk management activities by:

- increasing the eligibility of both hedged items and hedging instruments
- introducing a more principles-based approach to assessing hedge effectiveness.

As a result, the new requirements should serve to reduce profit or loss volatility. The increased flexibility of the new requirements are however partly offset by entities being prohibited from voluntarily discontinuing hedge accounting and also by enhanced disclosure requirements. The table gives a highly summarised view of the new requirements.

IFRS 9's hedge accounting requirements at a glance

Features	Key points
Objective of the Standard	• to better align hedging from an accounting point of view with entities' underlying risk management activities
Similarities with IAS 39	• hedge accounting remains an optional choice • the three types of hedge accounting (fair value hedges, cash flow hedges and hedges of a net investment) remain • formal designation and documentation of hedge accounting relationships is required • ineffectiveness needs to be measured and included in profit or loss • hedge accounting cannot be applied retrospectively
The major changes	• increased eligibility of hedged items • increased eligibility of hedging instruments and reduced volatility • revised criteria for hedge accounting qualification and for measuring hedge ineffectiveness • a new concept of rebalancing hedging relationships • new requirements restricting the discontinuance of hedge accounting

For more information on IFRS 9's hedge accounting requirements, please refer to our Special Edition of IFRS News '**IFRS 9 Hedge accounting**' which can be obtained from your local IFRS 9 contact.

Own credit

Amendments made in November 2013 allowed IFRS 9's so-called 'own credit' requirements to be applied in isolation without the need to change any other accounting for financial instruments. These requirements are relevant where an entity chooses to measure its own debt at fair value, IFRS 9 requiring the amount of the change in fair value due to changes in the entity's own credit risk to be presented in other comprehensive income. The requirements address the counterintuitive way in which a company in financial trouble was able to recognise a gain in profit or loss based on its theoretical ability to buy back its own debt at a reduced cost.

Mandatory effective date

The November 2013 amendments to IFRS 9 also removed the 1 January 2015 mandatory effective date of the Standard in order to provide sufficient time for entities to make the transition to the new requirements. In February 2014 the IASB tentatively decided to require an entity to apply IFRS 9 for annual periods beginning on or after 1 January 2018. Entities may still apply IFRS 9 immediately if they choose to however.

Expected publication of further chapters in the Standard

According to the IASB's work plan, it expects to publish additional changes to IFRS 9 in the second quarter of 2014. These changes are expected to amend the existing classification and measurement requirements of the Standard and to add a new chapter dealing with impairment. We summarise below the expected changes based on the information available at the time of writing.

Classification and measurement

IFRS 9 currently requires an entity to classify financial assets at either amortised cost or fair value on the basis of the entity's business model for managing the financial assets and the contractual cash flow characteristics of the financial asset (unless it chooses to designate the financial asset at fair value through profit or loss). Gains and losses on financial assets measured at fair value are required to be presented in profit or loss although an exception exists under which an entity may, on initial recognition, make an irrevocable election to present in other comprehensive income subsequent changes in the fair value of an investment in an equity instrument that is not held for trading.

In November 2012, however, the IASB published an Exposure Draft proposing limited amendments to the existing classification and measurement requirements of IFRS 9. It is expected that the result of these proposals will be the introduction of a fair value through other comprehensive income (FVOCI) measurement category for debt instruments that would be based on an entity's business model. To minimise the changes to IFRS 9's requirements, the amendments are expected to be consistent with the business model driven classification structure of the Standard. At the time of writing, it was expected that amendments reflecting these proposed changes would be finalised in the second quarter of 2014.

Impairment

In March 2013, the IASB published the Exposure Draft 'Expected Credit Losses'. The Exposure Draft proposed an alternative to the incurred loss model that would use more forward-looking information. The proposals also looked to address the perceived complexity of IAS 39 by applying the same impairment model to all financial instruments that are subject to impairment accounting.

Under the proposals, recognition of credit losses would no longer be dependent on the entity first identifying a credit loss event. An entity would instead consider a broader range of information when assessing credit risk and measuring expected credit losses, including:

- past events, such as experience of historical losses for similar financial instruments
- current conditions
- reasonable and supportable forecasts that affect the expected collectability of the future cash flows of the financial instrument.

In applying this more forward-looking approach, the IASB is expected to make a distinction between:

- financial instruments that have not deteriorated significantly in credit quality since initial recognition or that have low credit risk and
- financial instruments that have deteriorated significantly in credit quality since initial recognition and whose credit risk is not low.

'12-month expected credit losses' are recognised for the first of these two categories while 'lifetime expected credit losses' are recognised for the second category.

An asset moves from 12-month expected credit losses to lifetime expected credit losses when there has been a significant deterioration in credit quality since initial recognition and the credit risk is more than 'low'. Hence the 'boundary' between 12-month and lifetime losses is based both on the change in credit risk and the absolute level of risk at the reporting date.

There is also a third stage in the model. For assets for which there is objective evidence of impairment, interest is calculated based on the amortised cost net of the loss provision.

Two simplifications are expected to be included in the chapter when it is published (current expectations are that this will be in quarter 2 2014) to address concerns over the complexity of the proposals:

1. for 'short term' trade receivables, an entity should always recognise a loss allowance at an amount equal to lifetime expected credit losses. Practical expedients, such as use of a provisioning matrix, are permitted.
2. for 'long-term' trade receivables (ones which constitute financing transactions under IAS 18 'Revenue') and lease receivables, entities would be allowed to choose an accounting policy to always recognise a loss allowance at an amount equal to lifetime expected credit losses.

20. Revenue future developments

The IASB and the US standard setter, the FASB, are nearing the publication of their new, converged Standard on revenue recognition ('the new revenue Standard'). At the time of writing, the IASB's work plan showed expected publication in the second quarter of 2014. The new revenue Standard will:

- replace IAS 18 'Revenue', IAS 11 'Construction Contracts' and some revenue-related Interpretations
- establish a new control-based revenue recognition model
- change the basis for deciding when revenue is recognised at a point in time or over time
- provide new and more detailed guidance on specific topics
- expand and improve disclosures about revenue.

Practical insight – Impact of the new revenue Standard

Needless to say, the new Standard will affect almost every revenue-generating entity that applies IFRSs; however, the extent of the impact on each entity's top line will vary. While the new revenue Standard has more guidance in areas where current IFRSs are lacking – such as multiple element arrangements and variable pricing – the extent of the impact for an entity will depend on its specific customer contracts, how it has applied existing Standards in the past and how those existing policies vary with the new, additional guidance provided in the new revenue Standard.

A single model for revenue recognition

The new revenue Standard will be based on a core principle that requires an entity to recognise revenue:

- in a manner that depicts the transfer of goods or services to customers
- at an amount that reflects the consideration that the entity expects to be entitled to in exchange for those goods or services.

Applying this core principle involves the following five steps:

1. Identify the contract with a customer
2. Identify the seperate performance obligations
3. Determine the transaction price
4. Allocate the transaction price to the separate performance obligation
5. Recognise revenue when or as an entity satisfies performance obligations

The below points provide a snapshot of some of the requirements in the new revenue Standard.

Multiple element arrangements

A customer contract may cover a bundle of goods or services (often referred to as multiple element arrangements). Existing IFRS revenue guidance is criticised for lacking guidance for these particular arrangements. The new revenue Standard will provide additional requirements and discussion on this topic.

The new revenue Standard will require performance obligations (POs) to be accounted for separately if 'distinct' ie:

- the customer benefits from the item on its own or along with other readily available resources; and
- the supplier does not provide a significant service of integrating the various POs.

If POs are distinct, the contract price will be allocated between them based on the estimated stand-alone selling price of each PO.

Timing of revenue

The new revenue Standard will allow revenue to be recognised as the work is performed only if control over the promised goods or services is transferred to the customer over time.

Broadly, this occurs if:

- the customer simultaneously receives and consumes the benefits; or
- the asset has no alternative use and the supplier is entitled to payment for performance-to-date and expects to fulfil the contract.

Variable pricing

If pricing is variable or contingent (eg performance-based fees), revenue will be recognised on a best estimate basis. This may be the single most likely amount, or an expected (probability-weighted) value. Variable revenue is also subject to a constraint aimed at ensuring that the amount recognised will not later be subject to a significant reversal due to a change in estimates.

Time value

Under the new revenue Standard, the contract price will be adjusted for a financing component where significant. As a practical expedient, the financing component can be considered insignificant if the time period between performance and payment is one year or less.

Contract costs

Contract fulfilment costs will be recognised as assets if they are expected to be recovered and other conditions are met, while incremental costs of obtaining a contract may be capitalised if similar conditions are met.

Specific issues

The new revenue Standard will provide specific guidance on various other transaction types including:

- non-cash consideration and asset exchanges
- rights of return and other customer options
- supplier repurchase options
- warranties
- principal versus agent
- licensing
- breakage
- non-refundable upfront fees
- consignment and bill-and-hold arrangements.

Disclosures

The new revenue Standard will require considerably more disclosure about revenue – including information about:

- customer contracts, such as the remaining performance obligations (backlog)
- key judgements made
- contract costs recognised as assets.

Transition and effective date

The new revenue Standard is expected to be effective for annual periods ending on or after 1 January 2017 while earlier application will be permitted. Transition will be retrospective, subject to various practical expedients.

Although the new guidance is expected to take effect only in 2017, management should begin their impact assessment much sooner.

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