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June 2011 – Quarterly edition

# iGAAP Newsletter
## Beyond the standards

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# Contents

# Upfront

The IASB has continued to be active this quarter, issuing more new and amended standards including a package of five new and revised standards addressing the accounting for consolidation, interests in joint arrangements and disclosure of interests in other entities which are our topic of focus this quarter.

The global financial crisis highlighted the importance of consistent fair value measurement and disclosure in IFRSs and US GAAP. A new standard, IFRS 13 *Fair Value Measurement* has been developed jointly with the Financial Accounting Standards Board (FASB), the US national standard setter to define fair value and prescribe how it is measured. The standard also sets out disclosures, some extensive, required about those fair value measurements. Although its development was partly driven by the financial crisis, IFRS 13 applies equally to non-financial items measured at fair value (e.g., investment property).

Also new this quarter are the revised standards on accounting for defined benefit pension plans (finalising proposals discussed in detail in our June 2010 newsletter) and presentation of other items of comprehensive income, and an update on the ASB's project to replace current UK GAAP.

Even without a new accounting standard to deal with, many accountants need to take a deep breath before embarking on the preparation of a cash flow statement. Our practical issue addresses some of the issues and questions arising in this area.

Finally, our interviewee is Professor Isobel Sharp CBE, a partner at Deloitte who specialises in corporate reporting and governance matters. She provides us with an insight into a project she is jointly chairing, in response to a request from the IASB, aimed at reducing financial statement disclosures.

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# Practical issue: Cash flow statements

Cash flow statements are a key tool used by investors to assess the value and future potential growth of a company.

IAS 7 *Statement of Cash Flows* requires all companies which report under IFRS and have cash transactions during a reporting period (or comparative reporting period) to present a cash flow statement. Where an entity has no cash transactions, it may consider it appropriate to make a statement to this affect to clarify why no cash flow statement is presented. Unfortunately there are no exemptions in IFRSs from preparing a cash flow statement, unlike UK GAAP where subsidiary companies which meet certain criteria are exempt.

IAS 7 specifies only three categories in which to classify cash flows; operating, investing and financing, which can be presented in an order chosen by the reporting entity. This contrasts with UK GAAP which requires nine categories to be presented in a specified order.

A number of questions arise when preparing a cash flow statement. We address some of these practical issues below.

### What is a 'cash equivalent'?

In order to establish which transactions should be reported in an IFRS cash flow statement, it is first necessary to consider what is included within the definition of cash and cash equivalents. UK GAAP concentrates solely on movements in cash. The definition of 'cash' is similar in UK GAAP and IFRS and usually includes 'cash on hand and demand deposits', i.e. cash that can be withdrawn without notice and without suffering any penalty. IAS 7 extends the cash flow statement to include 'cash equivalents'. It can be harder to determine whether a balance meets the IAS 7 definition of a cash equivalent 'a short-term, liquid investment readily convertible to known amounts of cash and which are subject to an insignificant risk in change in value'. Additionally the standard requires that cash equivalents are held for the purpose of meeting short-term cash commitment purposes and not for investment and other purposes. As such, it is suggested that the cash equivalent will *normally* have a maturity of three months or less from the date of the acquisition, but this is not an absolute criteria.

The following table indicates whether certain investments are likely to be considered cash equivalents, although each case should be considered individually.

| Cash equivalent – ✓ | Cash equivalent – ✗ |
|---|---|
| • Foreign currency (if it meets the criteria of cash equivalent i.e. short-term liquid investment). | • Equity investments. |
| • Bank overdraft (if repayable on demand and an integral part of entity's cash management). | • Gold bullion. |
| | • Short-term loans. |
| | • Advances from factors. |
| | • Credit import loans. |

It is possible that an entity may hold a balance for cash management purposes in one period, and classify it as a cash equivalent, but in the following period use the balance for financing purposes so it may not be considered a cash equivalent. Where this is the case, this does not constitute a change in accounting policy (as per IAS 8) and there is no requirement to adjust the prior year balances reported in the cash flow statement.

### Should cash flow balances be reported on a gross or net basis?

IAS 7 only allows cash flows to be reported on a net basis for two reasons:

| Net basis | Example |
|---|---|
| Receipts and payments on behalf of customers when the cash flows reflect the activities of the customer rather than those of the entity. | • Collection of rent on behalf of owner of property.<br>• Funds held for customers by an investment bank. |
| Receipts and payments for items in which the turnover is quick, the amounts are large and the maturities are short. | • Advances and repayments of principal amounts relating to credit card customers.<br>• Purchases and sales of investments.<br>• Short-term borrowings with a maturity period of three months of less. |

There are additional situations where a financial institution can report cash flow on a net basis.

The specific titles of the categories in IAS 7 (operating, investing and financing) should be used in the cash flow statement and only in exceptional circumstances are different titles allowed when the use of these standard titles is misleading to the user of the accounts. Sub-headings may be added.

### Classification of cash flows

All cash flows are classified as investing, financing or operating. The definitions of investing and financing cash flows are specific with all other cash flows falling into the classification of operating.

#### What is an investing cash flow?

Investing cash flows arise as a result of acquiring or disposing of long-term asset and other investments e.g. payments to acquire, or receipts on sale of property, plant and equipment, intangible assets, other long-term assets or equity or debt instruments that are not held for dealing purposes; loans made to other parties; and payments in respect of capitalised development costs.

A modification to IAS 7 in 2009 (effective for periods beginning on or after 1 January 2010) clarifies that an investing cash flow will only arise when it results in a recognition or derecognition of an asset in the statement of financial position.

#### What is a financing cash flow?

Financing cash flows are those which change the contributed equity and the borrowings of an entity e.g. cash receipts as a result of issuing shares or other equity instruments; payments to purchase or redeem shares in the entity; and the part of the payment under a finance lease which is treated as repayment of the loan in the statement of financial position.

#### What is an operating cash flow?

'Operating' is the residual category i.e. all cash flows which are not investing or financing cash flows are classified as operating cash flows e.g. cash received from customers in respect of sales of goods or services; payments to suppliers; rental payments on properties used in business operations; and royalties received.

#### How should operating cash flows be reported?

The standard gives two choices of method to present cash flows from operating activities. It encourages the use of the direct method, which reports each major class of gross cash receipts and gross cash payments separately. However, in the UK the use of the indirect method remains the preferred choice, probably due to its similarity to the presentation under UK GAAP, and it is therefore the indirect method which is discussed further here.

The indirect method of reporting operating cash flows starts with the profit or loss reported by the entity, adjusts it for items reported in profit or loss that don't affect cash, to end up with the net cash from operating activities. The items adjusted for are:

- any non-cash items included in its calculation (e.g. depreciation and provisions);
- net profit items for the period for which cash flows were reported in an earlier period, or will be reported in a later period and cash flows that have yet to affect profit, i.e. changes in inventories, operating receivables and payables; and any items in the profit and loss which relate to investing or financing cash flows.

An illustrative example of a full cash flow statement can be found in the Deloitte publication *iGAAP 2011 – Financial Statements for UK listed groups.*

Information on how to obtain a copy is available from your local Deloitte contact or www.deloitte.co.uk/auditpublications

An example of how these adjustments are commonly presented is shown below:

| | | Year ended 20XX<br>£ | Year ended 20YY<br>£ |
|---|---|---|---|
| | | | |
| **Profit for year** | | | |
| | | | |
| **Adjustments for:**<br>*Including e.g.*<br>Interest charge for the year<br>Income tax charge for the year<br>Depreciation of property, plant and equipment<br>Impairment of goodwill | | | |
| **Operating cash flows before movements in working capital**<br>Increase in inventories<br>Decrease in trade and other receivables<br>Increase/(decrease) in trade payables | | | |
| **Cash generated by operations** | | | |
| Income taxes paid *(actual cash paid)*<br>Interest paid *(actual cash paid)* | | | |
| **Net cash from operating activities** | | | |

### Which profit or loss is used as a starting point?

There is no clarification in IAS 7 on which 'profit or loss' should be used as the starting point for the indirect method. The example included in the appendix of the standard starts with profit before taxation so this is assumed to be the preferred treatment.

Sometimes entities will need to start with a different 'profit or loss' balance, for example where discontinued operations are presented in the income statement, since the cash flow statement must include cash flows from both continuing and discontinued operations. One approach could be to start with 'profit for the year', as this includes both continuing and discontinued operations, and adjust for all the items described above to arrive at the net cash from operating activities. Although this method provides a clear link between items in the statement of comprehensive income and those in the statement of cash flows, it can result in rather a long list of adjustments. An alternative could be to start with operating profit from continuing operations (where this is presented) and add to this the operating profit from discontinued operations. This would reduce the number of adjustments to be made in arriving at the net cash from operating activities but it is not so easily linked to the amounts presented in the statement of comprehensive income.

Where entities choose to start with a different 'profit or loss' balance, careful consideration will need to be made of which balances to adjust this for in order to be able to present the cash flows correctly.

### How should interest and dividends paid and received be classified in the cash flow statement?

An entity has the choice of how to classify its interest and dividends provided that the classification is consistently applied from period to period. Dividends paid will normally be reported as either a financing or operating cash flow.

The standard states that interest paid and received and dividends received should generally be stated as operating cash flows for a financial institution. For all other entities, they may be classified as operating activities as they are included in arriving at the profit or loss for the period in the income statement, but entities may consider it more appropriate to classify these cash flows as financing or investing. Indeed, the most recent annual survey on financial statements produced by Deloitte ('Drowning by numbers' see www.deloitte.co.uk/auditpublications) found that of companies which reported interest received, 57% presented this as an investing cash flow.

One question that has arisen is whether interest capitalised as a borrowing cost, e.g. capitalised into the cost of property, plant and equipment, can be classified as 'investing'. This has been discussed by the Interpretations Committee who has recommended that the Board amend IAS 7, through the annual improvements process, to clarify that such interest cash flows should be classified in a manner consistent with the classification of the underlying asset to which those payments were capitalised. Since this is referred to as a clarification this might be seen as best practice today.

**How should cash flows in a foreign currency be dealt with?**

This is a common question that comes up when preparing a cash flow statement. There are different types of foreign exchange differences that can arise in practice:

*Scenario 1 – external transactions in a foreign currency*

- Where an entity enters into external transactions in a foreign currency, the cash flows relating to the transaction should be translated into the functional currency at the exchange rate on the date the cash flow occurs. Where this rate is different from that used on initial recognition in the income statement or statement of financial position, a foreign exchange difference will arise.

For example, an entity whose functional currency is Sterling, purchases a machine for $1,000. If the exchange rate at the date of the transaction is $2:£1 the entity would post the following entry:

| | |
|---|---|
| Dr property, plant and equipment | £500 |
| Cr payable | £500 |

The invoice is settled 30 days later when the exchange rate is $2.5:£1 and the following entry is booked:

| | |
|---|---|
| Dr payable | £500 |
| Cr cash | £400 ($1000/2.5) |
| Cr foreign exchange difference | £100 |

The £100 foreign exchange gain would be recognised in profit or loss. In the cash flow statement the purchase of the machine would result in a £400 investing cash flow. Therefore, if the operating cash flows are shown using the indirect method, the £100 foreign exchange difference would be one of the adjustments to profit before tax as it is part of an investing cash flow.

However, if the item purchased is inventory rather than property, plant and equipment, the £400 cash paid would be an operating, rather than an investing, cash flow. In this scenario there is no need to adjust profit or loss when using the indirect method for the exchange difference of £100. This is because the cost of the inventory (£500) and the foreign exchange difference of £100 would both have already been recognised in arriving at profit or loss for the year (or as an adjustment in the operating profit reconciliation were the inventory unsold at year end).

So, where the original cash flow is an investing or financing cash flow, the related foreign exchange difference which has arisen on the transaction should be included as an adjustment when using the indirect method of reporting operating cash flows.

*Scenario 2 – consolidating foreign subsidiaries*

- IAS 7 requires a foreign subsidiary's cash flows to be included in the group cash flow statement translated at the exchange rate on the date of the cash flow, although an average exchange rate is permitted if it is a good approximation to the actual rate.

  Where a group prepares its consolidated cash flow statement by taking foreign subsidiary cash flow statements and translating them at the rate that was used for the income statement translation, with intragroup cashflows translated at the rate on the date they occurred to ensure they eliminate on consolidation, no particular translation difficulties arise.

  In practice the consolidated cash flow statement is often prepared using the consolidated balance sheet and income statement, rather than the underlying cash payments and receipts. Where this approach is taken, since the foreign subsidiary's balance sheet is translated at the closing rate and income and expense items are translated at the exchange rate on the date of the transaction, or as an approximation, the average exchange rate, adjustments need to be made otherwise the cash flows will be misstated.

| Foreign subsidiary transaction | Exchange rates | Consolidated accounts |
|---|---|---|
| Dr debtor $100 | Year end rate $2/£1 | Dr debtor £50 |
| Cr revenue $100 | Average rate $1.5/£1 | Cr revenue £67 |
| | | Dr OCI £17 |

In the sterling denominated group accounts assuming the debtor is unsettled the difference between the revenue at average rate and debtor at year end rate results in a £17 foreign exchange difference being taken to OCI.

In preparing the consolidated cash flow (using the indirect method and the consolidated income statement and balance sheets), the profit figure taken from the consolidated income statement would include £67 of revenue not yet received. Thus the adjustment must reflect the movement in debtor at the average exchange rate, i.e. the movement per the balance sheet and the related foreign exchange movement take to OCI.

So, taking a cash flow statement that is to be presented at average rate (as this approximates to actual rate), in arriving at the net operating cash flows using the indirect method, it will be necessary to adjust the starting profit for the period by the change in working capital expressed at the average rate. Adjusting for the movement, in say debtors, per the consolidated balance sheet will not result in the correct adjustment as it does not take into account the foreign exchange difference resulting from the opening balance sheet being translated at a difference exchange rate to the closing one. Where the impact of this is material it is in practice necessary to restate the opening and closing balance sheets at average rate for the purpose of preparing the consolidated cash flow statement. The adjustment will eliminate against the foreign exchange difference that was taken to OCI and so this difference should not appear as an item in the cash flow statement or reconciliation to operating profit.

*Scenario 3 –foreign currency cash and cash equivalents*

- Where an entity has cash or cash equivalent balances held in foreign currencies, the effect of the foreign exchange rate changes on these balances is shown as a reconciling item in the statement of cash flows in order to show the movements in cash and cash equivalents from the start to the end of the period. This line in the cash flow statement must only include changes related to foreign currency cash and cash equivalent balances. Other exchange differences arising on consolidation of foreign subsidiaries (see above) should be adjusted for in the main part of the cash flow statement itself as described above and not in this line. This is an area of frequent misunderstanding and was highlighted in a recent FRRP case (http://www.frc.org.uk/frrp/press/pub2311.html).

### What about non-cash transactions?

Where an entity enters into an investing or financing transaction which is not reported in the cash flow statement as it does not involve the use of cash or cash equivalents, disclosure should be provided in the financial statements providing a user with all the relevant information about the transaction. Examples include the acquisition of an asset by way of a finance lease and the issue of bonus shares to holders of the entity's equity.

### Looking to the future …

#### Will the new consolidation standards impact the cash flow statement?

Yes. IFRS 11, the new standard on joint arrangements, eliminates the option to proportionally consolidate joint ventures. Where, as a result of this an entity has to move to equity accounting for a joint venture, it will subsequently only report the cash flows between itself and that joint venture, i.e. dividends, advances, and not its proportionate share of the joint ventures cash flows as it has done previously.

#### How will the proposed introduction of the FRSME impact the requirement for a cash flow statement?

Whilst the FRSME is based on IFRS for SMEs which mandates that all companies should prepare a cash flow statement (as with full IFRSs), the ASB have proposed to retain the exemption which currently exists under UK GAAP for subsidiary companies not to prepare a cash flow statement. Therefore, companies which transition to the FRSME and are currently exempt from preparing a cash flow statement will continue to make use of this exemption if they so wish. Companies which transition to full IFRSs, however, will have to report a cash flow statement.

# A coffee with … Isobel Sharp

Professor Isobel Sharp CBE is a partner at Deloitte LLP. She specialises in corporate reporting and governance matters, and is a Visiting Professor at the University of Edinburgh Business School. Isobel has served on the UK's Accounting Standards Board and the Financial Reporting Review Panel and was President of The Institute of Chartered Accountants of Scotland for 2007-2008. She is a Board member of the Independent Parliamentary Standards Authority which creates and operates the system for MPs' expenses and related matters.

**Overall how do you think IFRS has performed to date?**

With worldwide adoption by over 100 countries, IFRS in that respect is a great success. I think in terms of what the IASB has done and the IFRSs it has issued over the last five or six years, it's been the victim of circumstances. In particular, I wish the USA would now come off the fence and make its mind up whether it is in or out. We could then get on with focussing on looking at IFRS on their own rather than looking to try and match them up with US GAAP. The focus should be what are the best accounting standards full stop.

**So you mean they have not been able to drive their own agenda?**

They have chosen to drive their agenda in a particular way to achieve a particular end. I wouldn't like to say it was out of their control.

**With that backdrop, the IASB has asked the Institute of Chartered Accountants of Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZICA) to undertake a project to recommend reductions in financial statement disclosures. You are jointly chairing this project. How is it progressing?**

In short, brilliantly, she said modestly. It's the first time I have co-chaired a working party where the working party members have never met in person. Indeed we meet in conference call at 8am UK time, 7pm NZ time. With a conference call they can only last probably about an hour and it's incredible how productive people have been, and so disciplined. In that environment they raise the key issues and everything else is dealt with by email. As a consequence we have been able to achieve a phenomenal amount in a matter of six months. This could be a model for future working parties!

**When do you expect the report to be available?**

We are hoping that it will be available in late July. The current intention is to present the findings to the IASB meeting which is happening in the third week of July and the results will be publicly available shortly thereafter.

**In your view, which standards are the main culprits in creating excessive disclosures that add little value to readers of the financial statements?**

We have got a clear view on that. You have endless pages of accounting policies, most of which just say we are complying with what the accounting standard requires and are full of accounting jargon. That, as we know from our research, is taking up 11% of financial statements at the moment. You have lots of pages taken up with long reconciliations, reconciling opening balances to closing balances for this year, the previous year, and possibly even the year before that, a lot of which highlight relatively immaterial numbers and don't pull out the big picture stuff. You then have some of my "favourite" standards, such as IFRS 7, where the view is that it works well for financial institutions but is OTT for non financial institutions. Other particular favourites include share based payments, income tax and a few other goodies. So those are the main culprits. Indeed it's these existing IFRSs which the IASB has asked us to tackle, not the new ones that have come out over the last few months.

**Any particular highlights to share with us?**

There are two highlights. What we have done is go through individual accounting standards and we will be recommending specific changes to the IASB. The second area on which we focus attention is how you use materiality in financial reporting. At the moment it seems to be a somewhat blunt tool and we will be proposing a more sophisticated approach that will enable us to use materiality more wisely and ensure that only important information is disclosed.

**How do you think the IASB are going to use your report? Is this just to look at the disclosures to date or perhaps put in place a framework for what they should be doing in future?**

We hope the IASB will consider doing what they have just done on extractive industries, that is issue our report for public comment. The comments will then be taken into account and the Board can swiftly amend the particular standards to get the benefits of reduced disclosure and focusing on disclosing only material information.

**You have a particular interest in the whole of the financial statements including the narrative within the whole annual report. Does your review extend to the front half and would you like to see more focus on this?**

This ICAS/NZICA review focuses solely on long standing IFRSs up to IFRS 8. So we certainly have not looked outwith the financial statements. You are right that this has been an interest of mine. You will recall last year we worked on a couple of research projects obtaining views and comments on the front half of the annual report and indeed we worked closely with the Department for Business, Innovation and Skills (BIS). We are expecting, in late July, the next stage of the project. BIS is due to issue a consultation paper setting out its proposals for the front half of the annual report and I am ever optimistic that this will result in meaningful progress.

**Focusing on the financial statements themselves, do you think it's excessive disclosure that means users find it increasingly difficult to understand what financial reports are trying to communicate?**

I don't think it is just excessive disclosure. I think accounting standards, in certain respects, are counter intuitive and that makes it difficult for users to understand. It's difficult because there is a lot of complexity in accounting standards, a few "flip flop" across bright lines and it's difficult to work out where things are. I think the use of jargon by accountants or preparers doesn't help. Indeed I think, looking back over accounting standards, any standard that seems to have a compromise in it makes the financial statements difficult to understand because you have moved away from understandable principles.

**Later in the year we expect the IASB to consult on its agenda going forward. Are there some particular topics you would like to see on that agenda?**

I have got three immediate candidates. First thing is I would like to see them consult on is whether people are seeking simplification across accounting standards. Secondly I am quite a fan of completing the conceptual framework. If students of accounting and users of accounting can understand the broad principles, then that's half the battle in understanding the financial statements. The third thing I would like to see on the agenda is an immediate deletion of IAS 12 and IFRS 2, but that's just my starting point.

**Do you think the new chairman and vice chairman will bring a different focus?**

Obviously I find it amusing that one Scots person retires and has to be replaced by two. I'm not sure you could say that there would be a different focus. Going back to my earlier comments, the IASB can't operate in isolation, it has to operate in the circumstances which it faces. If the US comes on board then the IASB may have a different focus.

**We have touched on simplification a number of times. Do you think it is possible to simplify standards and do you think they will be simpler ten years down the line?**

I hope that they will be different ten years down the line. I hope they will be short, sharp, straight forward and simple – a bit like myself! If they are not I fear for the standing of financial reporting. It will no longer be a main stream activity. It will be a minority sport enjoyed by dull people without any real life and as a consequence it will not be valued. I see change which I think involves making standards more intuitive, easier to apply and if that is simplification then I am up for it.

**The IASB's IFRS for SMEs seeks to simplify accounting standards and I know you take a particular interest in this area and also in the future of UK GAAP reporting. Do you support the ASB's proposals to introduce a regime for qualifying subsidiaries so that they can follow the recognition and measurement requirements in full IFRSs but with reduced disclosures?**

I would hope that if the ICAS /NZICA proposals are accepted and there is a broader reduction in the disclosure regime, then the pressure for Tier 1s, as I call it, the regime for qualifying subsidiaries will reduce dramatically. I have sympathy with the proposals since the current 3000 disclosures are excessive particularly for subsidiaries. But I would also like the government to move on making available the exemptions in the Seventh Directive for subsidiaries which are part of a group guarantee regime.

**Moving more on to your role in Deloitte technical department, you have got a very wide range of responsibilities. Are there any that you find more enjoyable or do you enjoy the diversity of your work?**

I'm Scottish and Presbyterian. I enjoy only suffering.

**Good, Bad, Ugly?**

| | |
|---|---|
| IFRS for SMEs | Good |
| The ASB's proposals to replace current UK GAAP | Ugly, because of their sheer complexity in many layers and tiers and bits here and bits there. This isn't a simple straight forward regime. This is one that suits techies but confuses the bleep out of everybody else. |
| The ICAEW | Good, bad and ugly |
| The new standards IFRS 12 and 13 which are disclosure only standards | Ask me in 2013. But if our approach works for the existing standards then I have offered to get my red pen out and review the new ones. |

# Topic of focus: Consolidations

On 12th May 2011, the IASB announced the issue of a package of new and revised standards described as being "improvements to the accounting requirements for off balance sheet activities and joint arrangements". While this description points to the origin of this project as being a response to the financial crisis, the package goes further than this by replacing or revising all IASB requirements dealing with consolidation and joint arrangements.

In summary, the five new or revised standards are:

| Title | Main features |
| --- | --- |
| IFRS 10 *Consolidated Financial Statements* | • Replaces SIC 12 *Consolidation – Special Purpose Entities* and most of IAS 27.<br><br>• Provides a new single consolidation model based on the principle of an investor having actual control of an investee. |
| IAS 27 *Separate Financial Statements* | Contains the unchanged residual accounting and disclosure requirements for investments in subsidiaries, joint ventures and associates when an entity prepares separate financial statements. |
| IFRS 11 *Joint Arrangements* | • Differentiates jointly controlled arrangements between 'joint ventures' and 'joint operations' based on the substance of the arrangement, and not the legal form of the investee.<br><br>• Prescribes the accounting for interests in joint operations. |
| IAS 28 *Investments in Associates and Joint Ventures* | • Prescribes the unchanged accounting for investments in associates using equity accounting.<br><br>• Guidance on equity accounting also applies to joint ventures as determined under IFRS 11 (proportional consolidation is no longer permitted). |
| IFRS 12 *Disclosure of Interests in Other Entities* | • Brings together all existing disclosure requirements related to interests in subsidiaries, joint arrangements and associates (note – there are no disclosure requirements in IFRS 10, IFRS 11 or IAS 28).<br><br>• Introduces new disclosure requirements, including an explanation of significant judgements in the application of IFRS 10 and 11, and information on unconsolidated structured entities. |

### What was wrong with SIC 12 and IAS 27?

Three factors are given in the IASB's Project summary and feedback statement on the issues with SIC 12 and IAS 27. Firstly, the IASB point to the inconsistency of approach between the two standards, with IAS 27 being based on a legal notion of power to control while SIC 12 focused more on economic risks and rewards. The IASB claim that this difference resulted in diversity in practice (although, in the author's view, there is little evidence that preparers or auditors had difficulty determining which standard to apply). The IASB's solution was to develop a single model based on the principle of control reflecting current ability and existing rights, i.e. actual ability to control unilaterally rather than theoretical ability if all parties exercised their legal powers however remote.

Secondly, the global financial crisis highlighted shortcomings in the disclosure requirements relating to structured entities. The IASB's solution is increased narrative disclosure to explain how control or joint control has been judged, and new quantitative disclosures for structured entities that are properly not consolidated, including intentions to provide additional support, for example for reputational reasons.

Thirdly, the IASB and FASB initially set out to produce a common converged standard. However, comparatively late in the day, FASB decided not to change its existing legally based requirements for voting interest entities, and to consider further fine tuning its recently introduced requirements on structured entities which are already similar to IFRS 10.

**How should preparers and auditors approach IFRS 10?**

The principles of IFRS 10 are:

1. classification should reflect all facts and circumstances considered together;

2. the outcome should be reconsidered when facts or circumstances change;

3. the first stage of analysis should be consideration of the purpose and design of the investee;

4. in addition to assessing the rights of the investor, consideration should also be given to the rights of other parties;

5. consolidation is not limited to what is structured in a legal entity, but may include a part of an entity that is economically separable, for example, a protected cell entity; and

6. consolidation is required where an investor has control, which is defined as power from existing rights, together with exposure to variable returns, and a link between that power and those returns.

In assessing whether an investor has power from existing rights, IFRS 10 includes guidance in which activities of the investee are relevant, which rights are substantive rather than merely protective, and how power without votes is assessed.

**What might be consolidated now that was previously excluded?**

Perhaps the most significant area where IASB expect a change towards more consolidation is where an investor does not exercise power through holding a majority of votes, but by other means coupled with an exposure to variable returns (although not necessarily a majority share of variable returns). The IASB term this situation as 'de facto' control, and give two scenarios where it may occur.

The first scenario where 'de facto' control exists may involve an investor with a significant minority share of votes, say 35%, but the remaining voting rights are widely dispersed and lack any organised basis for acting in concert to restrict the investor acting unilaterally to control in practice.

The second scenario where 'de facto' control exists may involve potential voting rights such as options to acquire voting rights or convertible instruments. Under IAS 27, only rights that were currently exercisable were taken into consideration. Under IFRS 10, rights which are exercisable in the future are also considered, and judgement needed as to whether the holder is able to use the future right to control decisions before exercise or conversion. Two relevant factors to consider would be the timing of exercise and the likelihood of exercise. For example, on timing , the nearer an option is to the date when it can be exercised, the more power it is likely to give the holder. On likelihood, where an option is 'in-the-money', that is exercisable at a price which is below the fair value of the voting rights, the more likely it is to be exercised and hence the more power it will give the holder. Conversely, where an option is exercisable only in the longer term, or is 'out-of-the-money', it is less likely to be relevant in determining control.

**What might be excluded now that was previously consolidated?**

The area where the IASB appear to assume there will be less consolidation is with certain structured or special purpose entities. Under SIC 12, where an investor was exposed to a majority of economic risks and returns, the entire entity may have been classified as a controlled special purpose entity and underlying assets and liabilities consolidated. Under IFRS 10, the investor may be judged not to have power from existing rights if there are few decisions to be made after initial set up, and the investor is not able to access or change the underlying assets and liabilities of the investee. The investor's interest is thus more akin to a financial asset, possibly a derivative instrument, which is accounted for under IAS 39 or IFRS 9 as appropriate.

### What else is different?

One area where, in the past, there was little specific guidance, and hence a risk of diversity in practice, was the treatment by fund managers of investment funds to which they provide management services and may have an equity stake. Such interests may have been structured as limited partnerships where the investment manager takes the role of the general partner.

The IASB has developed guidance to assist classification based on whether an investment manager's role is that of an agent of other investors providing management for a performance-based fee, or a principal having both power over key decisions and exposure to variable returns (although not necessarily a majority interest). Classification as principal (hence consolidation) or agent (not consolidated) depends on consideration of four factors:

1. the design of the structure and the resulting authority and risks held by each party;

2. whether rights to remove the manager which are held by investors are substantive (i.e. there is a realistic possibility of them being invoked) or merely protective;

3. whether the remuneration paid to the manager is consistent with the management services provided; and

4. the level of equity investment held by the manager, and whether that interest is fully proportionate or takes a disproportionate share of returns or losses.

In our view, the conclusions likely to be reached from applying these principles will be broadly consistent with the approach taken by Deloitte under existing standards. Currently there are differences at a detailed level between IFRS 10 and the US GAAP guidance. However, FASB expect to expose the agent principal guidance soon.

### Will many joint ventures need to be reclassified?

The main change to accounting for joint arrangements is a reduced emphasis on the legal form of the joint arrangement, and increased emphasis on the economic substance. Under IAS 31, a jointly controlled arrangement structured as a separate entity would have been classified as a joint venture. Under IFRS 11, there is scope to look through the entity's structure, and classify according to whether the interest of each venturer is a share of net assets and net profit (which is a joint venture that is equity accounted), or a more direct interest in specific assets, liabilities, revenue and expenses (which is a joint operation with more specific accounting). Entities that have adopted joint venture accounting due to the structure of the joint venture entity may therefore need to review their joint arrangements.

### Are there any new disclosures?

While many disclosures are simply relocated into IFRS 12, there are two significant new disclosures:

1. a requirement to provide a narrative explanation of how IFRS 10 and 11 have been applied to support the classifications reached, especially where a majority voting interest is not consolidated, or a minority voting interest is consolidated; and

2. extensive disclosures related to unconsolidated structured entities that were originally sponsored by a reporting entity in order to explain the relationship and circumstances under which the reporting entity might provide support.

### Timetable for change

All the Standards are effective for accounting periods beginning on or after 1 January 2013, but early application is permitted for the package as a whole. The Standards are yet to go through the process for endorsement though the current EFRAG EU endorsement status report states that it expects the Standards to be endorsed before their effective date.

# Activities of the IASB

**IASB publishes final standards on consolidation, joint ventures and disclosures**

The IASB has published a"package of five" new and revised standards addressing the accounting for consolidation, involvements in joint arrangements and disclosure of involvements with other entities.

Each of the five standards have an effective date for annual periods beginning on or after 1 January 2013, with earlier application permitted so long as each of the other standards in the 'package of five' are also early applied. However, entities are permitted to incorporate any of the disclosure requirements in IFRS 12 into their financial statements without technically early applying the provisions of IFRS 12 (and thereby each of the other four standards).

IFRS 10 ***Consolidated Financial Statements***

IFRS 10 replaces the consolidation guidance in IAS 27 *Consolidated and Separate Financial Statements* and *SIC 12 Consolidation – Special Purpose Entities* by introducing a single consolidation model for all entities based on control, irrespective of the nature of the investee (i.e., whether an entity is controlled through voting rights of investors or through other contractual arrangements as is common with special purpose entities). Under IFRS 10, control is based on whether an investor has 1) power over the investee; 2) exposure, or rights, to variable returns from its involvement with the investee; and 3) the ability to use its power over the investee to affect the amount of the returns.

IFRS 11 ***Joint Arrangements***

IFRS 11 introduces new accounting requirements for joint arrangements, replacing IAS 31 *Interests in Joint Ventures*. The option to apply the proportional consolidation method when accounting for jointly controlled entities is removed. Additionally, IFRS 11 differentiates between joint operations and joint ventures. A joint operation is a joint arrangement whereby the parties that have joint control have rights to the assets and obligations for the liabilities. A joint venture is a joint arrangement whereby the parties that have joint control have rights to the net assets.

IFRS 12 ***Disclosure of Interests in Other Entities***

IFRS 12 requires enhanced disclosures about both consolidated entities and unconsolidated entities in which an entity has an interest. The objective of IFRS 12 is to require information so that financial statement users may evaluate the basis of control, any restrictions on consolidated assets and liabilities, risk exposures arising from interests in unconsolidated structured entities and non-controlling interest holders' interests in the activities of consolidated entities.

IAS 27 Separate Financial Statements (2011)

The requirements relating to separate financial statements are unchanged and are included in the amended IAS 27. The other requirements of IAS 27 are replaced by IFRS 10.

IAS 28 *Investments in associate and joint ventures (2011)*

IAS 28 continues to include guidance on application of the equity method amended for conforming changes based on the issuance of IFRS 10, IFRS 11 and IFRS 12.

It includes new guidance on the application of IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*, requiring the held for sale guidance to be applied to an investment, or portion of an investment in an associate or joint venture meeting the criteria.

The press release can be found at
http://www.ifrs.org/News/Press+Releases/IFRS+10+11+12+published+May+2011.htm

Deloitte in the UK has issued iGAAP Alerts covering IFRS 10, IFRS 11 and IFRS 12 in more detail. They are available at www.deloitte.co.uk/auditpublications

Deloitte in the UK has issued an iGAAP Alert covering IFRS 13 in more detail, which is available at www.deloitte.co.uk/auditpublications

**IASB issues fair value measurement and disclosure requirements**

On 12 May 2011, the IASB issued IFRS 13 *Fair Value Measurements*, which establishes a single source of guidance for all fair value measurements accounted for under IFRSs. It applies to both financial and non-financial items.

IFRS 13 doesn't introduce any new or revised requirements regarding which items should be measured or disclosed at fair value, instead it (1) defines fair value, (2) provides guidance on how to determine fair value, and (3) requires disclosures about fair value measurements. Applying the new standard may result in changes to the method of measurement of an item and additional disclosure about its measurement.

IFRS 13 is effective for annual periods beginning on or after 1 January 2013 with early application permitted.

The press release can be found at http://www.ifrs.org/News/Press+Releases/IFRS+13+FVM+May+2011.htm

Deloitte in the UK has issued an iGAAP Alert covering this topic in more detail, which is available at www.deloitte.co.uk/auditpublications

**IASB introduces improvements to the accounting for post-employment benefits**

The IASB has completed its project to improve the accounting for pensions and other post-employment benefits by issuing an amended version of IAS 19 Employee Benefits. The amended standard aims to give users of financial statements a clearer understanding of an entity's obligations under defined benefit plans, their impact on the primary statements and the risks associated with those commitments.

The amendments achieve this by:

- eliminating the 'corridor method' such that a deficit or recoverable surplus is recognised in full;
- removing the options available for the presentation of gains and losses relating to defined benefit plans. Service and finance costs are to be included in profit and loss and remeasurements in other comprehensive income (OCI), thereby separating those changes from changes that many perceive to be the result of an entity's day-to-day operations. Finance costs will be a net finance cost on the net defined benefit asset or liability; and
- improving the disclosure requirements for defined benefit plans to better explain the characteristics of defined benefit plans and the risks arising from those plans.

The amended version of IAS 19 is effective for financial years beginning on or after 1 January 2013, with earlier application permitted although this is subject to EU endorsement.

The press release can be found at http://www.ifrs.org/News/Press+Releases/IAS+19+June+2011.htm

**IASB issues amendments to align presentation requirements for other comprehensive income**

The IASB and the Financial Accounting Standards Board (FASB), the US national standard setter, have issued amendments that improve and align the presentation of OCI in financial statements prepared in accordance with IFRSs and US GAAP.

The amendments to IAS 1 retain the option to present profit or loss and other comprehensive income in either a single continuous statement or in two separate but consecutive statements.

The main change, in practice, is that items of other comprehensive income will be required to be grouped within the statement of other comprehensive income on the basis of whether they might at some point be recycled from OCI to profit or loss at a later date, when specified conditions are met. Tax on items of other comprehensive income is required to be allocated on the same basis.

Subject to EU endorsement, the amendments to IAS 1 are effective for financial years beginning on or after 1 July 2012.

The press release can be found at http://www.ifrs.org/News/Press+Releases/OCI+16+June+2011.htm

## IASB publishes proposals for amendments under its annual improvements project

The IASB has issued an exposure draft proposing amendments to five IFRSs as part of its programme of annual improvements to its standards.

The changes proposed are:

| IFRS | Subject of amendment |
|---|---|
| IFRS 1 First-time Adoption of IFRSs | • Repeated application of IFRS 1<br>• Borrowing costs relating to qualifying assets for which the commencement date for capitalisation is before the date of transition to IFRSs |
| IAS 1 Presentation of Financial Statements | • Clarification of requirements for comparative information<br>• Consistency with the updated Conceptual Framework |
| IAS 16 Property, Plant and Equipment | • Classification of servicing equipment |
| IAS 32 Financial Instruments: Presentation | • Income tax consequences of distributions to holders of an equity instrument, and of transaction costs of an equity transaction |
| IAS 34 Interim Financial Reporting | • Interim financial reporting and segment information for total assets |

The proposed amendments, if finalised, would be effective for annual periods beginning on or after 1 January 2013, with earlier application permitted. The comment period ends on 21 October 2011.

The press release (with a link to the exposure draft) can be accessed at http://www.ifrs.org/News/Press+Releases/API+ED+22+June+2011.htm

Deloitte in the UK has issued an iGAAP Alert covering this topic in more detail, which is available at www.deloitte.co.uk/auditpublications

## IASB to re-expose revenue recognition proposals

The IASB and the FASB are to re-expose the proposals for a common revenue recognition standard to enable interested parties to comment on revisions the boards have undertaken since the publication of an exposure draft on revenue recognition in June 2010. The Boards felt that given the importance of the revenue project and the volume of changes that have been proposed, it would be appropriate to re-expose the draft.

The press release can be obtained at http://www.ifrs.org/News/Press+Releases/re-expose+rev+rec+June+2011.htm

Deloitte (Global) publish IFRS Project Insights updates to provide a quick overview of the key projects of the IASB. The edition relating to the Revenue Recognition project can be found here http://www.iasplus.com/insight/revenue.pdf

## Updated convergence plan

The IASB and FASB have published a progress report on their convergence efforts.

Following the completion of their work on fair value measurement and the presentation of other comprehensive income, and the publication by the IASB of its package of consolidation standards, they will give priority to the three remaining MoU projects covering financial instruments accounting, leasing and revenue recognition, as well as the IASB only project on insurance accounting.

Completion is expected in the second half of 2011. The progress report is available to download from the IASB and FASB websites.

## Keeping up with IASB projects

The IAS Plus website (www.iasplus.com), maintained by Deloitte include *IASB Project Insights*. These documents (in easily printed PDF format) provide a quick overview of the key projects of the IASB, with a summary of:

- **Current status** – brief background and current steps being undertaken.
- **Key decisions and proposals** – high-level summaries of decisions to date and any consultation documents published.
- **'Thinking ahead'** – key considerations for entities given the status of the project
- **Next steps** – forthcoming deadlines or due process steps to be undertaken and guidelines as to when the project may be finalised.

The IASB Project Insights for the IASBs current agenda topics can be found at http://www.iasplus.com/insight/insight.htm

# UK GAAP Round Up

Deloitte in the UK issued a ukGAAP alert covering the October 2010 proposals in more detail. In addition, this was a topic of focus in our December 2010 iGAAP newsletter. Both are available at www.deloitte.co.uk/auditpublications

**Latest developments in the ASB's proposals for the future of UK GAAP**

The Accounting Standards Board (ASB) received over 290 comment letters in response to its Financial Reporting Exposure Drafts (FREDs) on the Future of Financial Reporting in the UK and Republic of Ireland, published in October 2010. It is currently developing its proposals in light of these responses.

The FREDs proposed a three-tier approach, which was developed and consulted on over the past six years. Companies with 'public accountability' would be in Tier 1 and be required to report under IFRSs as endorsed by the European Union in both consolidated and company only financial statements. Companies currently able to use the UK FRSSE would be Tier 3 and would continue to be able to follow the simplified version of UK standards. All companies in between (Tier 2) would report under the Financial Reporting Standard for Medium-sized Entities (FRSME) – a standard based on the IFRS for SMEs, modified to comply with UK and EU law and by replacing the tax section of the IFRS for SMEs with IAS 12 *Income Taxes*.

At its meeting on 16 June 2011 the Board tentatively decided to:

1. reduce the scope of Tier 1 such that the requirement to apply EU-adopted IFRS is not extended beyond that currently required by UK law;

2. change the principles for amending the IFRS for SMEs (on which the FRSME is based) to permit or require accounting options that exist in current UK GAAP; and

3. defer the effective date by six months to 1 January 2014.

The proposals included an option for qualifying subsidiaries to follow a reduced disclosure regime. The ASB deferred a decision on whether to introduce this regime until further work has been carried out on the FRSME.

A summary of the ASB's deliberations on the future of UK reporting can be found at http://www.frc.org.uk/asb/technical/projects/dev_month_2011.cfm

**ASB publishes Report on Cutting Clutter from Annual Reports**

The Accounting Standards Board (ASB) has published a report – Cutting Clutter: Combating clutter in annual reports. The report provides preparers of annual reports with practical aids for reducing clutter, giving ideas for how disclosures might look without the clutter, and factors to consider when planning the annual report process. The deadline for comments is 30 September 2011.

In due course the Government will be consulting further on the framework of narrative reporting. The Financial Reporting Council (FRC) will coordinate its work with that and also seek further debate on how materiality should be applied to financial statement disclosures.

The report can be found at http://www.frc.org.uk/asb/press/pub2566.html

**Financial Reporting Council consults on Boardroom Diversity**

In light of the recommendations set out in Lord Davies' report 'Women on Boards in February, the FRC has begun consultation on whether the UK Corporate Governance Code should be revised to require listed companies to publish their policy on gender diversity in the boardroom and report against it annually.

Views are also sought on whether the Code should identify some of the key issues to be considered when boards carry out their regular effectiveness reviews, and on the timing of any changes that might be made to the Code as a result of the consultation.

The period of consultation closes on 29 July 2011. A decision on whether to amend the Code and, if so, the timetable for doing so, will be announced later in the year.

Further details can be found at http://www.frc.org.uk/press/pub2574.html

### DEFRA Publishes consultation document on UK companies reporting of Greenhouse gas (GHG) emissions

The UK Department for Environment, Farming and Rural Affairs (Defra) has published its consultation document on whether the Government should make it mandatory for some UK companies to report on their greenhouse gas (GHG) emissions, or whether the Government should continue to encourage measuring and reporting of GHG emissions on a voluntary basis.

Section 85 of the Climate Change Act 2008 requires the Government to make regulations, under the Companies Act 2006, by 6 April 2012 requiring the directors' report of a company to include information about GHG emissions as is specified in regulations, or to lay a report before Parliament explaining why no such regulations have been made.

The document presents 4 options:

Option 1: Enhanced voluntary reporting

Option 2: Mandate under Companies Act for all quoted companies

Option 3: Mandate under Companies Act for all large companies

Option 4: Mandate under Companies Act for all companies whose UK electricity consumption exceeds a threshold (linking into the qualification criteria in the UK CRC Energy Efficiency Scheme).

The consultation period ends on 5 July 2011.

Further details can be found at http://www.defra.gov.uk/consult/2011/05/11/ghg-emissions/

### New Financial Reporting Review Panel Deputy Chair appointed

The Financial Reporting Council (FRC) has announced the appointment of Joanna Osborne as Deputy Chair of the Financial Reporting Review Panel (FRRP). The appointment will take effect from 1 June 2011.

Joanna Osborne has recently retired as a partner at KPMG. She has extensive technical knowledge of global financial reporting, audit and business issues and was a member of KPMG's International Financial Reporting Group (IFRG) from 2001-2003.

# IFRS issued but not yet effective or endorsed by the EU

| Title | Subject | Mandatory for accounting periods beginning on or after | Endorsed* or when endorsement expected (EFRAG 10 June 2011) |
|---|---|---|---|
| **IAS/IFRS standards** | | | |
| IFRS 9 (November 2009, revised October 2010) | Financial Instruments: Classification and Measurement | 1 January 2013 | To be confirmed |
| IFRS 10 (May 2011) | Consolidated Financial Statements | 1 January 2013 | Q3 2012 |
| IFRS 11 (May 2011) | Joint Arrangements | 1 January 2013 | Q3 2012 |
| IFRS 12 (May 2011) | Disclosures of Interests in Other Entities | 1 January 2013 | Q3 2012 |
| IFRS 13 (May 2011) | Fair Value Measurement | 1 January 2013 | Q3 2012 |
| IAS 27 (May 2011) | Separate Financial Statements | 1 January 2013 | Q3 2012 |
| IAS 28 (May 2011) | Investments in Associates and Joint Ventures | 1 January 2013 | Q3 2012 |
| Amendments to IFRS 7 (October 2010) | Transfers of financial assets | 1 July 2011 | Q3 2011 |
| Amendments to IAS 12 (December 2010) | Deferred tax: recovery of underlying assets | 1 January 2012 | Q1 2012 |
| Amendments to IFRS 1 (December 2010) | Severe Hyperinflation and Removal of Fixed Dates for First-Time Adopters | 1 July 2011 | Q1 2012 |

* The critical date when considering endorsement is the date of approval of the financial statements

# ASB and IASB timetables

**ASB Current Projects**

| | |
|---|---|
| The Future of UK GAAP | • In October 2010, the ASB issued two Financial Reporting Exposure Drafts ('the FREDs') on the future of UK GAAP.<br>• In March 2011 the ASB issued FRED 45 setting out proposals to be included in a Financial Reporting Standard for Public Benefit Entities (FRSPBE) to accompany the FRSME.<br>• Comments on this FRED are due by 31 July 2011.<br>• The closing period for comments on the October 2010 FREDs closed at the end of April 2011. ASB received over 290 responses and is considering its proposals in light of these responses.<br>• Tentative decisions to date include deferring the effective date to 1 January 2014; reducing the scope of Tier 1 and introducing accounting options that exist in current UK GAAP and align with EU adopted IFRS. |
| Convergence | • The ASB and the UITF continually consider what consequential amendments will be needed to UK GAAP once the IASB and IFRIC finalise standards, amendments and interpretations.<br>• 'Improvements to Financial Reporting Standards 2010' issued November 2010. |

**IASB Project Timeline – Active Projects**

| | |
|---|---|
| Annual Improvements to IFRSs – 2009-2011 | • Final IFRS issued May 2010.<br>• Further ED issued June 2011. |
| Conceptual Framework<br>Eight phases in all | • ED on objectives and qualitative characteristics was issued in May 2008. Final chapter issued September 2010.<br>• ED on reporting entity was issued in March 2010, deliberations not expected to continue until after June 2011.<br>• Consideration of remaining phases not expected until after June 2011. |
| Consolidation, including SPEs* | • Final IFRS replacing IAS 27 and detailed disclosures on unconsolidated entities issued May 2011.<br>• ED on proposed changes for investment companies expected Q3 2011. |
| Fair Value Measurement Guidance | • Final IFRS issued May 2011. |
| Financial Instruments (replacement of existing standards) * | • Classification and measurement of financial assets, IFRS issued November 2009.<br>• Classification and measurement of financial liabilities, IFRS issued October 2010.<br>• Impairment ED issued November 2009, general hedging ED issued December 2010, additional impairment ED issued January 2011 and final IFRSs expected second half of 2011.<br>• ED on asset and liability offsetting issued January 2011 and final IFRS expected second half of 2011.<br>• ED on macro hedge accounting expected in second half of 2011. |
| Financial Statement Presentation*<br>Phase B: Statement of information in the financial statements | • Final IFRS issued June 2011. |
| Insurance Contracts – Phase II | • Final IFRS expected first half of 2012. |
| Joint Arrangements | • Final IFRS issued May 2011. |

| | |
|---|---|
| Leases* | • ED issued August 2010.<br>• Round tables December 2010 and January 2011.<br>• Final IFRS expected first half of 2012. |
| Post-employment Benefits (including Pensions)* | • Final IFRS on defined benefit plans and termination benefits issued June 2011. |
| Revenue Recognition* | • DP issued December 2008.<br>• ED issued June 2010, followed by round tables November 2010.<br>• Re-exposure expected Q3 2011.<br>• Final IFRS expected first half of 2012. |

* IASB projects with milestones agreed in the February 2006 IASB-FASB Memorandum of Understanding on convergence – download the MoU at www.iasplus.com/pressrel/0602roadmapmou.pdf.

This timetable is derived from the IASB's published timetable supplemented by decisions and comments made at recent meetings of the Board. You will find details on each project, including decision summaries from each Board meeting, at www.iasplus.com/agenda/agenda.htm

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