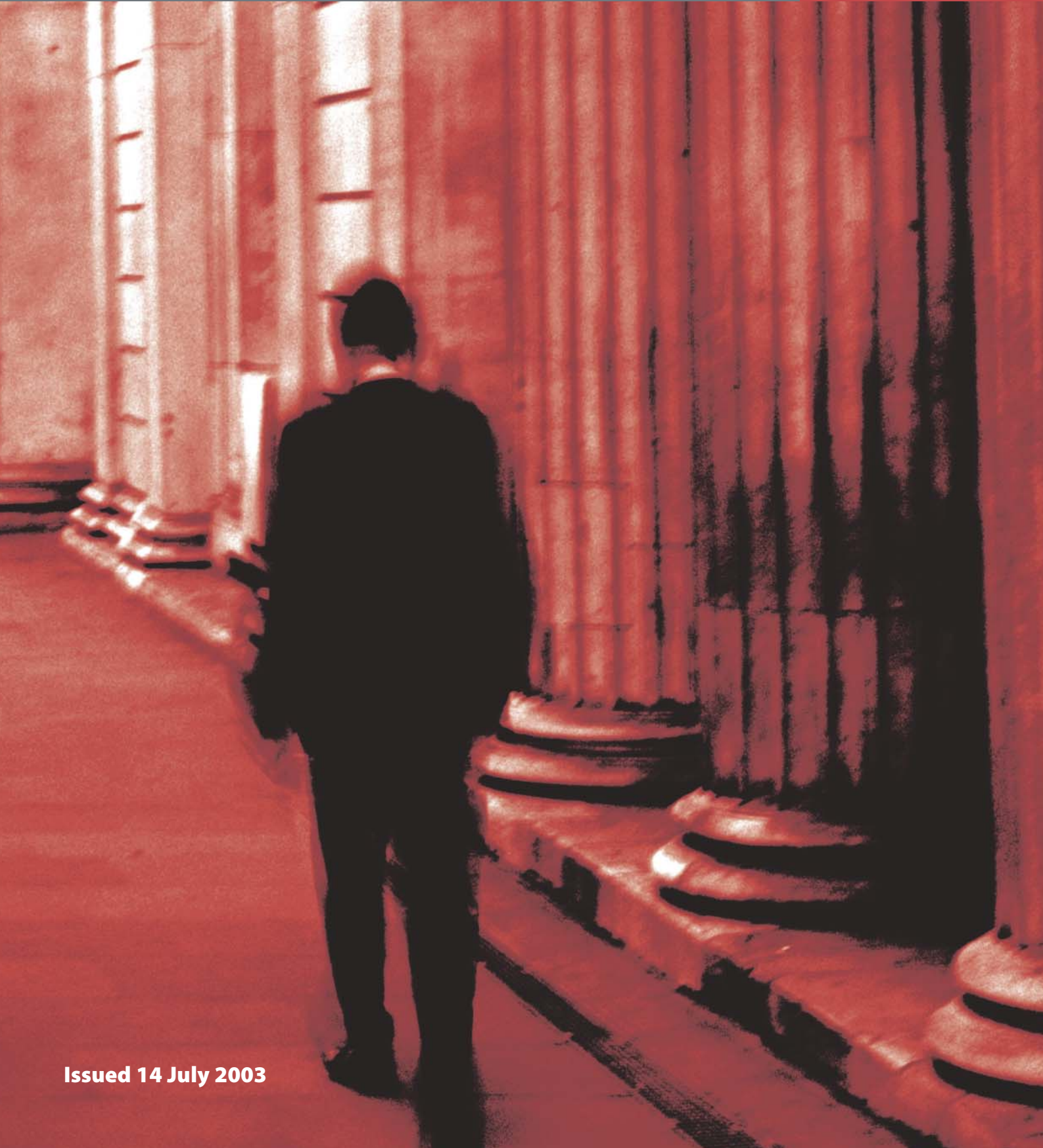


ASSURANCE & ADVISORY – DISCUSSION PAPER 2003-02

# First-Time Adoption of International Financial Reporting Standards



**Issued 14 July 2003**

*This document has been prepared as a general guide to the matters covered. It is not possible to cover all the situations that may be encountered in practice and, in addition, readers may have alternative solutions to some of the questions raised and answers offered. Accordingly, this document should not be viewed as a substitute for detailed reading of the associated accounting pronouncements or professional advice on specific matters of concern. Whilst every effort has been made to ensure that the information contained in this document is accurate, neither Deloitte Touche Tohmatsu nor any of its partners, directors, principles, consultants or employees shall be liable to any party in respect of decisions or actions taken as a result of using the information in this document.*

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## 1. Executive Summary

On 16 June 2003, IFRS 1 'First-Time Adoption of International Financial Reporting Standards' was issued by the International Accounting Standards Board (IASB), to be effective for financial years beginning on or after 1 January 2004. An equivalent converged AASB Standard has yet to be issued due to perceived copyright and legal issues, however it is expected that the Standard will be issued in Australia with an effective date of financial periods beginning on or after 1 January 2005.

IFRS 1 provides the 'framework' to be adopted when an entity first applies International Financial Reporting Standards (IFRS). In the Australian context, the IFRS 1 requirements will effectively apply on first time adoption of all IFRS converged AASB Standards, expected for financial periods beginning on or after 1 January 2005.

The expected requirements of the converged AASB Standard are as follows:

- IFRS converged AASB Standards will need to be retrospectively applied when first adopted, with certain limited mandatory and optional exceptions; and
- comparative information will need to be fully restated to comply with the converged AASB Standards, from as early as 1 January 2004 for entities with December year ends.

An entity will be prohibited from retrospective application on matters related to:

- derecognised financial assets and financial liabilities;
- hedge accounting; and
- measurement of estimates (affect of subsequent events).

An entity may elect to use one or more exemptions relating to the following:

- choosing not to retrospectively apply the converged AASB Standards to prior business combinations;
- using current fair value or certain prior revaluations as deemed cost for certain non-financial assets;
- previous event driven fair value measurements;





- electing to recognise all cumulative actuarial gains and losses at the date of transition relating to the measurement of a defined benefit asset or liability;
- deeming cumulative translation differences for all foreign operations to be zero at the date of transition;
- measurement of component parts of certain compound financial instruments;
- certain measurement options where entities (or associates or joint ventures) in a group become IFRS compliant at different dates.

In many respects, entities are given a 'fresh start' and will be required to redetermine their accounting policies under the converged AASB Standards, fully restating past comparative information. The limited optional exceptions will also present some opportunities for entities to determine optimal outcomes.

However, with the IASB reissuing the majority of the existing IFRS on issue, and more than 30 new converged AASB Standards expected in the next 12 months, entities will face a significant challenge in determining the impacts of convergence.

*The information in this document is based on the AASB and IASB Standards and Exposure Drafts current as of 14 July 2003. A number of Standards expected to be effective in 2005 are still to be issued, either as final Standards or even as Exposure Drafts. Where relevant, reference is made to IASB and AASB Exposure Drafts on issue or projects currently being undertaken, but readers of this Discussion Paper should note that the AASB and IASB due process may result in final Standards which are different to the current proposals.*

This paper does not address in detail all the options available and current differences between Australian accounting standards and IFRS, but attempts to highlight the key issues an entity will face when converged AASB Standards are first applied. However, convergence is not just an accounting issue, as significant business issues will also arise because of convergence. These issues will need to be addressed in an entity's implementation plan to ensure a smooth transition to the new regime.

Entities should not underestimate the business implications and the amount of work involved. The planning and approach to convergence with IFRS needs to be considered by all entities now.

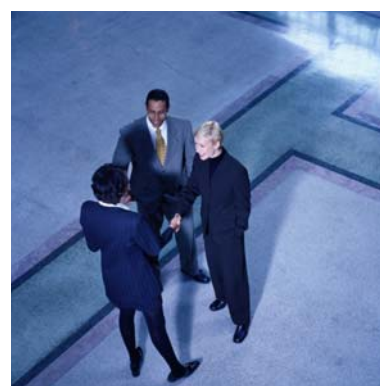
## 2. Harmonisation in Australia

The Australian Accounting Standards Board (AASB) has for a number of years been developing Accounting Standards with a view to international harmonisation. However in the past few months their harmonisation policy has changed to a 'convergence' approach, whereby the AASB intends to adopt IFRS as equivalent AASB Standards, with some minor exceptions. This change has been instigated by the Financial Reporting Council and the Federal Government with the release of Issue Paper No. 9 'Corporate Disclosure – Strengthening the Financial Reporting Framework' under its Corporate Law Economic Reform Program.

Although subject to the IASB adhering to their timetable, the AASB intends to issue around 35 new or revised Accounting Standards by 31 March 2004. These Accounting Standards would apply to all entities complying with Accounting Standards in Australia, and therefore convergence with IFRS will need to be addressed by all entities. Due to the inter-relationships that exist within IFRS, the AASB has adopted a 'big-bang' approach to convergence and all these Accounting Standards will be applicable from 1 January 2005.

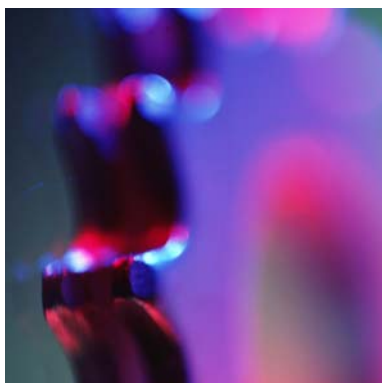
It is intended that the new/revised Accounting Standards will converge with IFRS, however as part of the due process, in addition to some specific issues on several IFRS, the AASB will seek opinions on whether:

- converging with the IASB is in the best interests of the Australian economy;
- there are any issues relating to not-for-profit entities, including not-for-profit public sector entities, that may affect the implementation of IFRS; and
- there are any regulatory or other issues arising in the Australian environment that may affect the implementation of IFRS.



*For further details on the harmonisation approach being adopted in Australia, refer to the Deloitte publication 'International Financial Reporting Standards Healthcheck 2003', available at [www.deloitte.com.au](http://www.deloitte.com.au).*

The impact of the convergence with IFRS will vary from entity to entity, depending on structure, operations, transactions and historical accounting policies. Despite Australia's previous harmonisation policy, a number of significant differences remain between IFRS and Accounting Standards in Australia. There are also a myriad of minor differences that many entities will need to identify and resolve. None of the 33 IFRS currently on issue are 100% compatible with Accounting Standards in Australia and most IFRS are also expected to be revised between now and 1 January 2005. As a result, the exact nature and requirements of Accounting Standards that Australian entities will apply from 1 January 2005 will not be known until at least March 2004. Australian entities will therefore need to consider the transition process in the context of concurrent changes.



## 3. Application in Australia

### 3.1. Objective of IFRS 1

The objective of IFRS 1 is to achieve high quality financial reporting amongst entities reporting under IFRS through information that:

- is transparent to users and comparable over all periods presented;
- provides a suitable starting point for the entity's subsequent accounting under IFRS; and
- can be generated at a cost that does not exceed the benefit to users.

To achieve this objective, IFRS 1 provides the framework to be adopted when an entity adopts IFRS and imposes overriding transitional provisions, which must be applied on first-time adoption. In principle IFRS 1 requires retrospective application of each IFRS effective at the reporting date of an entity's first IFRS compliant financial statements, with certain limited exceptions as detailed in sections 4 and 5.

### 3.2. Application Date

#### 3.2.1. General Requirements

IFRS 1 is applicable to entities adopting IFRS for the first-time as their basis of accounting for periods beginning on or after 1 January 2004, although earlier adoption is encouraged. A first-time adopter is an entity that, for the first-time, makes an explicit and unreserved statement that its general purpose financial statements comply with IFRS. In Australia, as AASB Accounting Standards will continue to exist, it is expected that first-time adoption will be considered in the context of converged AASB Standards applicable for financial periods beginning on or after 1 January 2005.

A 'first-time adopter' includes entities that may have prepared IFRS financial statements for internal management purposes only, or stated compliance only with limited IFRS, but does not include entities who reported under both Australian GAAP and IFRS, or reported under IFRS and received a qualified audit opinion.

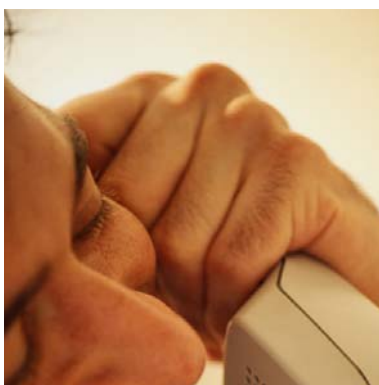


*Throughout the remainder of this Discussion Paper it is assumed that IFRS 1 is adopted as a converged AASB Standard on a 'word-for-word' basis, with an application date of 1 January 2005.*

Copyright and legal issues have delayed the release of a converged AASB Standard equivalent to IFRS 1. The AASB is currently working to resolve these issues, with the intention of issuing some form of interim guidance in the near future if an Australian converged standard cannot be issued until early in 2004.

IFRS 1 requires the restatement of one year of comparative information, therefore the principles of IFRS 1 may effectively be applicable from 1 January 2004. However, an earlier effective application date may apply where an entity elects or is required by regulatory requirements to restate more than one year of comparatives.

To assist in the restatement of comparatives, an opening balance sheet at the 'date of transition' should be prepared, the date of transition being the date at the beginning of the earliest comparative period restated. Both IAS 1 'Presentation of Financial Statements' and the current version of AASB 1018 'Statement of Financial Performance', AASB 1034 'Financial Report Presentation and Disclosure' and AASB 1040 'Statement of Financial Position' require at least one year of comparatives. If additional comparative periods are presented, an entity can choose whether or not to restate these additional periods. Where additional comparative information is presented under Australian (or another) GAAP, an entity shall label the information as such and disclose the nature (quantification not required) of the main adjustments to comply with IFRS. There are special provisions for US foreign private issuers (refer 3.2.3).



### **3.2.2. Interim Financial Reporting**

IFRS 1 applies equally to annual reporting periods and interim financial reporting periods presented under IAS 34 'Interim Financial Reports'. Therefore, half-year financial statements in the year the first IFRS financial statements are prepared will also be impacted. Note, the requirement to prepare a half-year financial report will continue to be governed by the *Corporations Act 2001* and will not change on the introduction of IFRS. As with AASB 1029 'Interim Financial Reporting', IAS 34 does not mandate which entities are required to publish interim financial reports.

Therefore, the key dates for IFRS compliant information for the most common reporting dates in Australia are expected to be:

	30 June Year Ends	31 December Year Ends
Date of transitional balance sheet	01/07/2004	01/01/2004
Half-year restated comparatives (where applicable)	31/12/2004	30/06/2004
Full year restated comparatives	30/06/2005	31/12/2004
IFRS compliant half-year financial report (where applicable)	31/12/2005	30/06/2005
IFRS compliant financial report	30/06/2006	31/12/2005

### 3.2.3. US Foreign Private Issuers

Australian entities that are US foreign private issuers are required to present a minimum of two years of comparative information in the income statement and statement of cash flows included in their financial statements lodged with the US Securities and Exchange Commission (SEC) under Form 20-F. In accordance with SEC Rules, all periods presented must be prepared using the same basis of accounting. Therefore, US foreign private issuers must restate at least two years of comparatives, causing their date of transition to be one year earlier than other Australian companies.

For selected financial data, an additional two years of information is required, but this information may be omitted where the information cannot be provided, or cannot be provided on a restated basis, without unreasonable effort or expense. The SEC has however stated that registrants should provide whatever information is available for the additional two years that is IFRS compliant.

As a consequence of these requirements it is possible that an Australian entity could have two different dates of transition where the Australian financial report only includes one year of comparatives. In such a case, given the exceptions outlined in section 5 to the general principle of full retrospective application, assets and liabilities may be recognised and measured differently for Australian versus US GAAP reporting. This may require, on an ongoing basis, the need to maintain two sets of accounting records and therefore it may be judicious to ensure the comparative periods restated and presented in the two sets of financial statements are consistent.





#### **3.2.4. Early Adoption**

As noted above, IFRS 1 has not yet been issued as an Australian Standard and therefore cannot yet be adopted by Australian entities. Accounting Interpretation AI 2 'Transition to AASB Equivalents of IASB Standards and Applying the Hierarchy of Pronouncements in AASB 1001 and AAS 6', recently issued by the AASB, clarified that IASB Standards and Interpretations on a topic can only be early adopted where there is not an equivalent AASB requirement. In such a case, the IASB requirements may be adopted where they are not inconsistent with any AASB pronouncements, including the definition and recognition criteria within SAC 4 'Definition and Recognition of the Elements of Financial Statements'. However in accordance with AASB 1001 'Accounting Policies', such a voluntary change in accounting policy must be (unless impracticable) retrospectively applied with the effect recognised in the statement of financial performance.

Note, when ED 108 'Request for Comment on: IASB ED 2 Share-based Payment' and ED 109 'Request for Comment on: IASB ED 3 'Business Combinations'; IASB ED on Proposed Amendments to IAS 36 'Impairment of Assets' and IAS 38 'Intangible Assets'; and AASB added material' were issued, the exposure drafts included either application dates prior to 1 January 2005 or were expected to allow early adoption. The possibility of early adoption is now however unclear as the AASB have indicated that early adoption will only be possible where all converged AASB Standards are adopted. As the full complement of converged AASB Standards are not expected to be issued until at least March 2004, the possibility of early adoption does not yet exist. The AASB is expected to revisit these conclusions following further progress on the current IASB Projects.

### 3.3. Which Accounting Standards?

All the AASB Standards converged with IFRS are to be issued over the coming nine months, with an expectation that any standard to be applicable in 2005 will be issued by 31 March 2004. That is, Australian entities will be required to comply with the AASB Standards that have been converged with IFRS, rather than IFRS directly. Accounting Standards issued and effective as at the reporting date of an entity's first IFRS compliant financial statements, should be used. For example, an entity with a 31 December 2005 financial year end would adopt those standards effective for financial periods beginning on or after 1 January 2005. Therefore, even though a standard may not have been issued as at the date of transition (that is, 1 January 2004 in the preceding example), it should still be applied retrospectively as if there was no preceding accounting standard with potentially different requirements. Note, many of the converged AASB Standards may not be issued until early 2004 but will be effective at the reporting date when all converged AASB Standards are adopted.

It is also possible to adopt a Standard whose application is not yet mandatory for the reporting period but where early adoption is permitted. The IASB has a number of projects currently on its agenda where standards are expected to be finalised prior to 1 January 2005 with application dates beyond 1 January 2005, for example, performance reporting and business combinations phase II. If equivalent standards are adopted in Australia prior to the end of the first reporting period when all converged AASB Standards are adopted, these later converged standards may be early adopted at that time.

Changes to current IASB Standards may arise due to current IASB projects but also due to amendments made by the AASB on adoption in Australia. Recent exposure drafts issued by the AASB have shown that in certain cases the AASB intends to still dictate that some choices under IFRS will not be available under converged AASB Standards. Therefore, we are still aiming at a moving target.

*Deloitte believe that converged AASB Standards should not modify the recognition, measurement or presentation requirements of the equivalent IFRS, and should only include additional disclosure requirements in exceptional circumstances. This overriding principle should be extended to the wording, format, layout and other aspects of IFRS, so that 'word for word' convergence is achieved where possible.*



Current Australian accounting standards apply equally to large and small corporates, not-for-profit entities and the public sector, and such application is expected to continue under converged AASB Standards. The IASB's focus is on major corporate reporting entities and as such issues in relation to not-for-profit and non-reporting entities may not have been fully explored. The AASB is addressing this issue in the review of converged AASB Standards under exposure but the final effect of converged AASB Standards on such entities is unresolved.

## 4. General Principles

### 4.1. Overview

As explained in section 3.2, an entity must prepare an opening IFRS converged balance sheet at the date of transition to IFRS converged AASB Standards. In general, IFRS 1 requires IFRS effective at the reporting date of the entity's first IFRS financial report to be applied retrospectively. As a result, an entity's opening balance sheet must, except for the limited exceptions discussed in section 5:

- recognise all assets and liabilities whose recognition is required by IFRS;
- not recognise items as assets or liabilities if IFRSs do not permit such recognition;
- classify recognised assets, liabilities and components of equity in accordance with IFRS; and
- apply IFRS in measuring all recognised assets and liabilities.

Any adjustments resulting from the restatement of the opening balance sheet shall be recognised directly in retained earnings, or if appropriate another category of equity, at the date of transition.

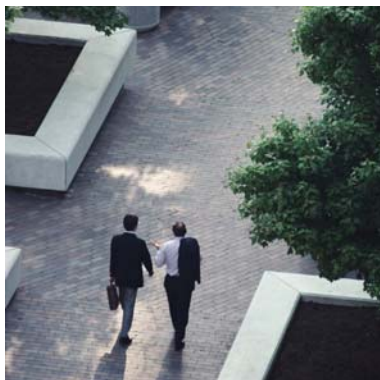
In the following sections, the impacts of these requirements are discussed with reference to certain standards where specific interpretive issues might arise. These should be considered in conjunction with the exemptions discussed in section 5.

### 4.2. Options Within Accounting Standards

On first-time adoption of IFRS, an entity must choose which accounting policies will be adopted. Certain IFRS provide an entity with an explicit choice between alternative accounting policies that may be applied in preparing financial statements. This choice may have a significant impact on future results. Once adopted an accounting policy should only be changed where the change will result in a more appropriate presentation, therefore opportunities to change may be restrictive.



*Further information about differences between Australian GAAP and IFRS can be found in the Deloitte Touche Tohmatsu publication 'Differences Between Australian GAAP and IFRS and the Future Direction of Accounting Standards', available at [www.deloitte.com.au](http://www.deloitte.com.au).*



Examples of areas where there is a choice of accounting policies under IFRS include, but are not limited to:

- Expensing versus capitalisation of borrowing costs (IAS 23);
- Cost versus revaluation basis of accounting for property, plant and equipment and intangible assets (IAS 16, IAS 38);
- Cost versus fair value basis of accounting for investment property (IAS 40);
- Treatment of investments in subsidiaries and associates in parent entity financial statements either at cost or at fair value under IAS 39 available for sale accounting (IAS 27, IAS 28, as proposed in the Exposure Draft 'Improvements to International Accounting Standards');
- Proposed choice to designate any financial instrument as trading (IAS 39);
- Hedge accounting (IAS 39); and
- Proportionate consolidation versus equity accounting of jointly controlled entities (IAS 31).

Before the measurement stage of first-time adoption can commence, decisions need to be made on which policies will be adopted. However, entities making such decisions need to be aware that certain choices within IFRS may be excluded by the AASB under converged AASB Standards.

### **4.3. Major Interpretative Issues**

#### **4.3.1. Intangible Assets (Excluding Goodwill)**

The full retrospective application of IAS 38 'Intangible Assets' requires the recognition of only those intangible assets that meet the recognition criteria of IAS 38, that is:

- it is probable that future economic benefits will flow to the entity; and
- the cost can be reliably measured.

These basic principles are consistent with Australian GAAP but the interpretation of these requirements and specific guidance under IFRS in relation to certain intangible assets, for example research and development costs and other internally generated intangibles, has resulted in accounting practice in Australia not being compliant with IAS 38, refer comparison below.

These criteria should not be assessed at the date of transition, but assessed at the time the costs were initially incurred, with no adjustments for hindsight. Therefore, at the date costs were initially incurred an entity must have had systems in place to make an assessment of future economic benefits and for accumulating costs. As with any intangible assets, where the recognition criteria is met at a later date, amounts originally expensed cannot be reversed and capitalised, only costs from the point the criteria are met are eligible for capitalisation. Amounts recognised or derecognised should include equivalent amortisation.

Normally any adjustments arising from the recognition or derecognition of intangible assets will be made through opening retained earnings. However where the intangible asset arose in a business combination, the adjustment should be made against goodwill as detailed in section 5.2.1. In such cases there are modified measurement conditions.

In addition, the deemed cost exemption, as detailed in section 5.2.2 is also applicable to intangible assets, however its application is limited to intangible assets which can be revalued to fair value under IAS 38. Such revaluations are only permitted where there is an active market for which there are limited examples in Australia.

#### IFRS versus Australian GAAP Comparison

IAS 38 requires that intangible assets must be recognised where they meet the 'identifiability' criteria, either the asset is 'separable' or arises from contractual or legal rights. Therefore intangible assets cannot be ignored and subsumed into goodwill in a business combination. As detailed in section 5.2.1, even though a prior business combination may not be restated, intangible assets that still exist at the date of transition cannot be ignored and must be separately recognised where the subsidiary is able to meet the recognition and measurement criteria. Other differences between Australian GAAP and IAS 38 that may cause adjustments include:

- A prohibition on the recognition of internally generated brands, mastheads, publishing titles, customer lists and similar items as assets. Where such assets are currently recognised under Australian GAAP these must be derecognised;
- Research costs should always be expensed and development costs can only be capitalised if very strict criteria are met;
- Revaluation of intangible assets would be restricted to fair value determined by reference to an active market, that is without an active market no revaluation is permitted. It is uncommon in Australia for an active market to exist for an intangible asset with some exceptions, for example, taxi-licences, fishing licences, production quotas, and water rights. An active market cannot exist for intangible assets such as brand names, newspaper mastheads, music and film publishing rights, patents, and trademarks, as each of these assets is unique by its nature;
- A prohibition on the capitalisation of expenditure related to start-up, training activities, advertising, promotional, relocation and other similar activities;





*It is possible that an impairment write-down or reversal of a write-down will be required at the date of transition despite no underlying change to the entity, in particular, where undiscounted cash flows have been used historically to determine recoverable amount.*

- The non-amortisation of intangible assets that have an indefinite life (ED 109 proposal). Note, the consequences of the proposal in ED 109 for a first-time adopter have not yet been addressed. IFRS 1 would currently require that any accumulated amortisation recognised in relation to indefinite life intangibles should be reversed. However this first-time adoption principle may be revised when ED 109 is finalised as it is inconsistent with the proposed transitional provisions of ED 109;
- The mandatory amortisation of finite life intangible assets;
- Residual value is assumed to be zero unless there is a commitment by a third party to purchase the asset or there is an active market for the asset.

#### 4.3.2. Impairment of Assets

At the date of transition, an impairment test under IAS 36 'Impairment of Assets' should be performed for most current and non-current assets where there is an indication of impairment. The impairment methodology under IAS 36 differs from that which exists under AASB 1010 'Recoverable Amount of Non-Current Assets' and therefore this in itself may necessitate the need for an impairment test.

As noted in section 5.1.3, the estimates used to calculate recoverable amount should be consistent with estimates previously made at the same date under Australian GAAP.

Where an impairment loss or reversal is recognised at the date of transition, disclosures will be required similar to those had the write-down occurred in a normal reporting period, and any adjustments should be recognised through opening retained earnings.

#### IFRS versus Australian GAAP Comparison

Differences between AASB 1010 and IAS 36 (as amended by the proposals in ED 109) that may cause adjustments include:

- Only test for impairment if trigger test met, that is, there is an indication of impairment.
- Recoverable amount will be determined as the higher of an asset's net selling price and value in use.
- In determining an assets value in use:
  - future cash flows must be discounted – the discount rate is determined on a pre-tax basis and future cash flows are also determined on a pre-tax basis; and
  - there are many restrictions on what information and assumptions can be used when determining future cash flows – particularly in relation to future capital expenditure and growth rates used.
- Goodwill acquired in a business combination must be allocated to the smallest individual cash generating unit (CGU) by the end of the first annual reporting period beginning after acquisition and will be subject to a 'two-step' annual impairment test as part of the impairment test for the CGU to which it relates.
- Impairment losses (except in relation to goodwill) must be compulsorily reversed in certain circumstance.

### 4.3.3. Classification of Financial Instruments

The full retrospective application of IAS 32 'Financial Instruments: Disclosure and Presentation' would require the classification of financial instruments issued as either financial liabilities or equity instruments in accordance with the substance of contractual arrangements when the instrument first satisfied the recognition criteria, without considering events subsequent to that date, other than changes to the terms of the instrument.

An exemption has been created in relation to compound financial instruments where the liability component is no longer outstanding, refer section 5.2.6, but otherwise no exemptions exist.

#### IFRS versus Australian GAAP Comparison

In general the classification of financial instruments under IAS 32 (as amended by the proposals in the Improvements ED) and AASB 1033 'Presentation and Disclosure of Financial Instruments' will produce similar results, however differences may exist in relation to:

- Obligations that can be settled with the issuer's own equity instruments;
- Financial instruments with contingent settlement provisions beyond the control of both the issuer and the holder;
- Redeemable financial instruments, for example, units in unit trusts and resetting preference shares;
- Equity-based derivatives; and
- Compound financial instruments issued before 1 January 1998.

### 4.3.4. Recognition and Measurement of Financial Instruments

IAS 39 'Financial Instruments: Recognition and Measurement' should be applied retrospectively from the date of transition except in relation to certain previously derecognised financial assets and financial liabilities (refer section 5.1.1) and hedge accounting (refer section 5.1.2). As such, in general all financial assets and financial liabilities should be recognised in an entity's opening balance sheet and measured in accordance with their designation under IAS 39.

IAS 39 requires financial assets to be designated to one of four sub-classifications for which different measurement requirements apply. Once designated an asset cannot be reclassified between categories unless either:

- there is evidence of a recent actual pattern of short-term profit taking that justifies such reclassification; or
- the financial asset is a held-to-maturity investments which is sold prior to maturity in which case the entire portfolio of such assets must be reclassified as either available for sale or held-for-trading and remeasured to fair value.<sup>1</sup>

<sup>1</sup> The IASB Exposure Draft 'Proposed Amendments To IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement' proposes to eliminate the option to reclassify a financial asset as held-for-trading post initial designation. On the tainting of a held-to-maturity financial asset portfolio, reclassification will be as an available for sale financial asset, rather than held-for-trading. Otherwise there is no ability to reclassify available for sale financial assets.

Classification	Measurement	Recognition
Held-for-trading	Fair value	Profit or loss
Available for sale	Fair value, subject to impairment	Equity <sup>2</sup>
Originated loans and receivables	Amortised cost, subject to impairment	Profit or loss
Held-to-maturity	Amortised cost, subject to impairment	Profit or loss

At the date of transition, the following guidance applies to the allocation of financial assets to these classifications:

- For held-to-maturity investments, the classification should reflect the entity's intent and ability at the date of transition. Therefore sales and transfers before the date of transition do not trigger the 'tainting' provisions.
- For loans and receivables originated by the entity, reference should be made to the circumstances at the date the asset was initially recognised.
- For financial assets held-for-trading, classification of non-derivative financial assets requires that the asset:
  - was acquired principally for the purpose of selling in the near term; or
  - at the date of transition, was part of a portfolio of identified financial instruments that were managed together and for which there was evidence of a recent actual pattern of short-term profit taking.
- Derivatives (including embedded derivatives) are always deemed held-for-trading.



Similar requirements exist in relation to financial liabilities, however there are only two sub-categories, held-for-trading financial liabilities that are measured at fair value with changes in fair value recognised in the profit or loss, and other financial liabilities that are measured at amortised cost. In designating financial liabilities between these two categories, the above comments in relation to held-for-trading financial assets equally apply.

<sup>2</sup> The IAS 39 Exposure Draft proposes to eliminate the current option of recognising changes in fair value in the profit or loss, however it will allow any financial asset to be designated as held for trading.

For those financial assets and financial liabilities that are measured at amortised cost, the cost should be determined based on the circumstances existing when the assets and liabilities first satisfied the recognition criteria. Financial assets and financial liabilities acquired in a business combination may be measured at their deemed cost in accordance with historical acquisition accounting under Australian GAAP under the specific exception discussed at 5.2.1.

Adjustments on initial adoption of IAS 39 should be recognised against opening retained earnings other than in relation to available for sale financial assets for which fair value adjustments should be recognised in a separate component of equity until the asset is derecognised or impaired.

#### **IFRS versus Australian GAAP Comparison**

Financial assets under Australian GAAP may be recognised at cost, fair value or net market value depending on the entity and the assets involved. Therefore the impact of convergence will vary between entities.

No specific guidance exists under Australian GAAP for the subsequent measurement of financial liabilities and these would normally be recognised at amortised cost.

The requirement for financial assets and financial liabilities to be recognised on-balance sheet under IAS 39 will result in more derivatives being recognised. To understand the impact of this requirement, refer to the discussion at 5.1.2.

A full inventory of financial assets and financial liabilities should be performed at the date of transition and the impact of alternative designation choices under the proposed revised IAS 39 considered. This inventory will include derivatives embedded within host contracts that are not necessarily financial instruments, such as leases and loan commitments. Such embedded derivatives may need to be accounted for separately.

#### **4.3.5. Income Taxes**

Revised AASB 1020 'Income Taxes' was fully harmonised with the 1996 version of IAS 12 'Income Taxes', but has not been revised for minor amendments made to IAS 12 in 2000. In November 2002, the mandatory application date of AASB 1020 was delayed until financial years ending on or after 31 December 2005. IAS 12 is a standard that is likely to be revised before the 1 January 2005 transition date as it is part of the IASB/FASB short-term convergence project. Given the complex change to accounting for income taxes that is introduced by AASB 1020, it is likely that many entities will not implement AASB 1020 in its current form, but will instead implement an IFRS converged AASB Standard.

*Note, revised AASB 1020 can be early adopted and would bring an entity largely in line with IAS 12. In such circumstances initial adjustments should be recognised against equity except where deferred tax relates to the initial recognition of a business combination, in which case goodwill (and associated amortisation) should be recalculated. The only means of achieving a similar result under IFRS 1 is to restate prior business combinations. If prior business combinations are not restated all adjustments arising as a result of convergence with IAS 12 will be recognised in equity and goodwill will not be adjusted.*

*Determining whether to early adopt revised AASB 1020 should be made in conjunction with a review of the optimal implementation date for tax consolidations. For a detailed analysis of the accounting for income taxes under the tax consolidation system, refer to the Deloitte Discussion Paper 2003-01 'Accounting for the Tax Consolidation System', available at [www.deloitte.com.au](http://www.deloitte.com.au).*



#### **IFRS versus Australian GAAP Comparison**

IAS 12 results in deferred tax assets and liabilities being created for temporary differences, being the difference between the carrying amount of an asset or liability and its tax base at a particular date. Some of the areas where IAS 12 will have a significant impact are:

- Fair value adjustments in acquisitions;
- Asset revaluations;
- Compound financial instruments;
- Translation of foreign operations; and
- Undistributed profits/impairments of investments in subsidiaries, associates and joint venture entities.

On first-time adoption, the deemed cost exemptions discussed in 5.2.2 and other exemptions may change the carrying values of assets and liabilities. The tax effect of such revisions should also be incorporated into any retained earnings adjustment. Therefore, even where an entity has early adopted AASB 1020 or performed initial impact studies, a full review of the impact of IAS 12 will need to be performed at the date of transition.

#### **4.3.6. Borrowing Costs**

The full retrospective application of IAS 23 'Borrowing Costs' requires an entity to first determine whether they will adopt a policy of capitalising or expensing borrowing costs.

Where an entity elects to adopt the benchmark treatment under IAS 23 of expensing all borrowing costs, retrospective application would require the entity to determine the amount of capitalised borrowing costs currently included in the carrying amount of assets and derecognise these amounts. Where such amounts cannot be determined, an entity will be required to apply one of the deemed cost exceptions discussed at section 5.2.2.

Where an entity elects to adopt the allowed alternative treatment under IAS 23 of capitalising borrowing costs related to qualifying assets adjustments may be required because when AASB 1036 'Borrowing Costs' was first adopted it only required prospective application from as early as 1 January 1998. Therefore, if an entity's policy prior to this date was inconsistent with the current capitalisation requirements, adjustments in relation to earlier periods will be required on transition to IFRS. Once again, if the deemed cost exceptions under section 5.2.2 are applied this can be avoided.

#### 4.3.7. Share-Based Payments

ED 108 'Request for Comment on IASB ED 2 Share-based Payment' includes prospective transitional provisions based on the date of the issue of the exposure draft being 7 November 2002, but does not propose any amendments to the requirements of IFRS 1. Therefore, as the exposure draft is currently written, its requirements will apply to a first-time adopter retrospectively, irrespective of the date on which the share-based payments were granted.

The IASB have indicated that with all new standards they will consider the transitional requirements separately for an entity that currently reports under IFRS and a first-time adopter. Where retrospective application is not appropriate for a first-time adopter, IFRS 1 will be amended. Therefore we may see amendments to IFRS 1 before it becomes applicable in Australia as new IFRS are issued.

*For a detailed analysis of ED 108, refer to the Deloitte Accounting Alert 2002-15 'Share-Based Payments Exposure Draft Issued', available at [www.deloitte.com.au](http://www.deloitte.com.au).*



*Retrospective application of all accounting requirements in the following three areas has been prohibited to prevent inconsistencies with entities already applying IFRS and management discretion being applied with hindsight.*



## 5. Exemptions

### 5.1. Mandatory Exemptions

#### 5.1.1. Derecognised Financial Assets and Financial Liabilities

Consistent with the transitional provisions of IAS 39 'Financial Instruments: Recognition and Measurement' financial assets and financial liabilities derecognised (through securitisations, transfers or extinguishment) in a financial year beginning before 1 January 2001 should not be reinstated unless they qualify for recognition as a result of a later transaction or event. However:

- Any derivatives or other interests (such as servicing rights and obligations in a securitisation) retained after the derecognition transaction and still existing at the date of transition must be recognised; and
- Where the derecognition transaction resulted in a special purpose entity (SPE), the SPE must be consolidated in accordance with SIC 12 'Consolidation – Special Purpose Entities', regardless of when the SPE was established. (Note, the international interpretation of SIC 12 is generally stricter than the Australian interpretation of UIG 28 'Consolidation – Special Purpose Entities' and may therefore lead to a great number of SPEs being consolidated.)

Note, this exemption may be amended or deleted when the IASB completes the improvements project in relation to IAS 39. This project proposes deleting this transitional provision.

#### IFRS versus Australian GAAP Comparison

There is little specific guidance currently under Australian GAAP with regards to the derecognition of financial assets, therefore entities will need to assess their current derecognition policies against the requirements of IAS 39. In relation to financial liabilities, Australian GAAP is similar to IAS 39, but AASB 1014 'Set-off and Extinguishment of Debt' allows debt subject to an in-substance defeasance to be treated as being extinguished if certain conditions are met. Such derecognition is not allowed under IAS 39 because the primary debt is not extinguished. Therefore any debt in existence at the date of transition subject to in-substance defeasance, will need to be recognised in the opening IFRS converged balance sheet where the amounts were derecognised post 1 January 2001.

## 5.1.2. Hedge Accounting

### IFRS versus Australian GAAP Comparison

Hedge accounting is permitted under IAS 39 in certain circumstances, provided that the hedging relationship is:

- Clearly defined – the risk being hedged and the expected relationship between that risk and the hedging instrument;
- Measurable – the technique used to assess hedge effectiveness; and
- Actually effective – if, despite strategies and expectations, the hedge was not effective, or was only partially effective, either the whole instrument, or only the ineffective portion, is not eligible for hedge accounting.

An entity must designate a specific hedging instrument as a hedge of a change in value or change in cash flows of a specific hedged item. The designation must be in writing, up front (no retrospective designations), and be consistent with an established risk management strategy. In essence, under IAS 39 hedge accounting is not mandatory. If an enterprise does not want to use hedge accounting, it simply does not designate a hedging relationship.

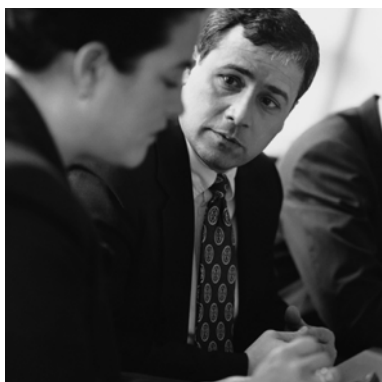
IAS 39 recognises three types of hedges. They are:

- Fair value hedges – a hedge of the exposure to changes in the fair value of an asset or liability that is already recognised in the balance sheet (such as a hedge of exposure to changes in the fair value of fixed rate debt as a result of changes in interest rates). The gain or loss from the change in fair value of the hedging instrument is recognised immediately in net profit or loss. At the same time, the carrying amount of the hedged item is adjusted for the corresponding gain or loss attributable to the hedged risk, which also is recognised immediately in net profit or loss.
- Cash flow hedges – a hedge of the exposure to variability in cash flows relating to:
  - a recognised asset or liability (such as all or some future interest payments on variable rate debt);
  - an unrecognised firm commitment (such as a non-cancellable fixed price purchase order)<sup>3</sup>; or
  - a forecasted transaction (such as an anticipated purchase or sale).To the extent that the hedge is effective, the portion of the gain or loss on the hedging instrument is recognised initially directly in equity. Subsequently, that amount is included in net profit or loss in the same period or periods during which the hedged item affects net profit or loss (for example, when cost of sales, depreciation, or amortisation are recognised).
- Hedges of a net investment in a foreign entity – these are accounted for as cash flow hedges.

In Australia, there are currently rules only in relation to foreign currency hedging which are far less prescriptive compared to IAS 39. Note, the IAS 39 rules extend to any financial instrument, derivative or non-derivative.



<sup>3</sup> The IASB Exposure Draft 'Proposed Amendments To IAS 32 Financial Instruments: Disclosure and Presentation and IAS 39 Financial Instruments: Recognition and Measurement' proposes to treat hedges of firm commitments as fair value hedges.



On the adoption of IFRS, to prevent the selective designation of hedges to report a particular result, new hedge accounting principles can only be applied prospectively from the date of transition. Therefore:

- Hedge accounting adopted prior to the date of transition will not be restated even if it is inconsistent with IAS 39, whether in relation to measurement, recognition, designation or other requirements.
- All derivatives must be measured at fair value.
- Hedge accounting can only be achieved where the designation, documentation and other criteria of IAS 39 are met at the date of transition.
- For fair value hedges, any gains or losses arising on the (re)measurement of the derivative would be recognised in opening retained earnings consistent with the ongoing recognition of gains or losses in the profit or loss.
- For cash flow hedges, deferred gains or losses previously recognised as assets or liabilities (or not recognised under Australian GAAP, for example, interest rate swaps) should be reclassified as a separate component of equity where at the date of transition designation and documentation requirements are met.
- Historical effectiveness tests are not required, however these tests must be complied with on an on-going basis.

#### Example – Cash Flow Hedge – Foreign Currency Swap

On 4 July 2003 Company Y forecasted US dollar purchases of US\$1 million to occur during the first 6 months of 2005. At the same time Company Y entered into a forward foreign currency swap for US\$1 million fixed at US\$0.65. The swap is designated as a hedge of the forecasted purchases and meets all the criteria for a cash flow hedge. Company Y has a 31 December reporting date. Under Australian GAAP the foreign currency hedge was recognised at spot rate at the reporting date and given the forecasted transaction had not yet occurred, the foreign exchange loss was deferred as an asset. Under IFRS, the fair value of the foreign currency hedge should be recognised as a separate component of equity and recognised in the profit and loss when the forecasted transaction occurs.

		Australian GAAP	IFRS
	Foreign currency hedge receivable/ (payable)	Deferred (gain)/loss on foreign currency contracts	Separate component of equity
4 July 2003	0	0	0
31 December 2003	(128,205)	128,205	Fair value
31 December 2003	(48,840)	48,840	Fair value

#### Example – Cash Flow Hedge – Interest Rate Swap

On 1 January 2003 Company X entered into a five-year pay fixed 5.5%, receive BBSW interest rate swap. The notional amount of the interest rate swap was \$100 million, to hedge a \$100 million five-year variable (BBSW) rate debt. The interest rate swap is designated as a hedge of the forecasted interest payments on the debt and meets all the criteria for a cash flow hedge. Company X has a 31 December reporting date.

	BBSW Rate	Fair Value of the Interest Rate Swap
1 January 2003	5.00%	0
31 December 2003	6.57%	4,068,000
31 December 2004	7.70%	5,793,000

Under Australian GAAP, the fair value of the interest rate swap will not have been recognised, but the effect of the interest rate swap will only have been recognised when payments were due under the interest rate swap contract. On transition, an interest rate swap asset of \$4,068,000 will be recognised at the date of transition with an adjustment recognised in a separate component of equity. The increase in the value of the interest rate swap of \$1,725,000 in 2004 will also be recognised through the separate component of equity.

#### 5.1.3. Measurement of Estimates (Effect of Subsequent Events)

Where estimates are required to be made in determining the opening balance sheet or comparative period information, these estimates should be consistent with estimates made for the same date under Australian GAAP. That is, subsequent events should not be taken into account unless there is evidence that the estimates were in error and thus estimates should reflect the same conditions as had been used previously. The only differences that should arise are where there is a change in accounting policy. Therefore, as the calculation of most provisions is consistent between Australian GAAP and IFRS, there should not be any opening balance restatements with respect to provisions even when revisions to estimates occurred under Australian GAAP in the 2004 financial year, provided the revisions to estimates did not reflect errors in the prior financial report. Such revisions to estimates should continue to be recognised in the profit or loss in the 2004 financial year.

If an estimate is required under IFRS that was not required under Australian GAAP (for example, the calculation of defined benefit plan obligations under IAS 19 'Employee Benefits'), the estimates should not reflect conditions that arose after the date of transition, but reflect market conditions and other expectations at the date of transition.



This ensures that the profit and loss in the first years after the date of transition reflect events as they occur and there are no adjustments through opening retained earnings for facts that wouldn't otherwise have been known at that date. Entities may wish to review estimates that will need to be made under IFRS at the date of transition rather than 2 years later when the first IFRS financial statements are issued. This will eliminate any subjectivity between what is considered to be a post-transition versus pre-transition change in estimate.

Alternatively, in some circumstances an entity may elect to early adopt the requirements of IFRS, as discussed in section 3.2.4, where allowed in accordance with AI 2. Circumstances where this may be possible include:

- Recognition of defined benefit plans (IAS 19);
- Impairment of assets methodology (IAS 36); and
- Tax-effect accounting (revised AASB 1020/IAS 12).

However, as required by AASB 1001, the effect of retrospective application of a revised accounting policy must be recognised in the statement of financial performance, rather than in opening retained earnings as will occur on first-time adoption under IFRS 1.

## 5.2. Voluntary Exemptions

### 5.2.1. Business Combinations

On first-time adoption of IFRS, an entity may elect to:

- not retrospectively restate business combinations recognised prior to the date of transition;
- restate all business combinations post a specific date (earlier than the date of transition); or
- restate all business combinations.

This exemption applies equally to past acquisitions of investments in associates and of interests in joint ventures with respect to the calculation of goodwill for the purpose of equity accounting.

*To apply the general principles of full retrospective application of all Standards was recognised as potentially requiring significant cost without equivalent benefits to the users of the financial statements. As a result, IFRS 1 grants first-time adopters limited exceptions from these requirements in the areas discussed below.*

*An entity may elect to adopt one or more of these exceptions but they cannot be used by analogy to other items. Where a particular exemption is not applied, full retrospective application is required.*

#### IFRS versus Australian GAAP Comparison

There are currently only a few major differences between the requirements of IAS 22 'Business Combinations' and AASB 1013 'Accounting for Goodwill' and AASB 1015 'Acquisition of Assets'; however if the proposals of ED 109 are approved these differences will extend to include:

- removal of the existing concessions in relation to the recognition of restructuring provisions arising in a business combination;
- contingent liabilities assumed in an acquisition will be initially recognised at fair value at acquisition date and at each subsequent reporting date;
- in-process research and development will be recognised as an asset, at fair value, when acquired as part of a business combination;
- 'reverse acquisition' accounting would be required in some circumstances;
- 'negative goodwill' (discount on acquisition) will be recognised immediately in net profit or loss; and
- goodwill will not be amortised, but will be subject to a 'two-step' impairment test as part of the impairment test for the cash generating unit to which it relates, potentially resulting in 'lumpy' profits when an impairment occurs.

It is expected that ED 109 will be effective for financial years beginning on or after 1 January 2005 and therefore would need to be applied at a minimum to acquisitions post 1 January 2004 (December year ends) or 1 July 2004 (June year ends). An entity must consider the following alternatives to determine whether the costs of restatement and other favourable accounting consequences of acquisitions prior to these dates outweigh the benefits that may exist from non-amortisation of goodwill.

##### 5.2.1.1. No Restatement of Business Combinations

Where an entity elects not to restate some or all of its past business combinations, previous acquisition accounting remains unchanged. However the general principles of first-time adoption still apply and thus all, but only those, assets and liabilities whose recognition is required by IFRS are to be recognised. Any adjustments resulting from the application of this principle should be recognised in opening retained earnings, other than adjustments relating to intangible assets as discussed below.

The measurement of all assets and liabilities acquired in a business combination, other than goodwill and intangible assets, as determined under Australian GAAP shall be their deemed cost under IFRS. Subsequent to the business combination, the restatement of assets and liabilities to be IFRS compliant should be recognised against retained earnings or other equity, where applicable. Examples include subsequent fair value measurements or where accumulated depreciation calculations are not IFRS compliant.





Assets and liabilities not recognised, but that would have been had IFRS been applied, should be measured on the basis that would be required if the acquiree were a first-time adopter at the same time as the acquirer. As such, the recognition and measurement criteria must be considered from the point of view of the acquiree. For example, contingent liabilities assumed in an acquisition, not previously recognised under AASB 1015 will not be recognised under transition to IFRS as the contingent liabilities would not be recognised by the acquiree in its separate IFRS financial statements. Any adjustments resulting from the recognition of such assets and liabilities should be made against opening retained earnings and not goodwill.

The carrying value of goodwill at the date of transition should be its carrying value as previously determined under Australian GAAP adjusted for:

- the reclassification of intangible assets (including any related deferred tax and minority interests):
    - to goodwill, where previously separately recognised acquired intangible assets do not qualify for recognition as intangible assets under IAS 38 'Intangible Assets'; or
    - from goodwill, where an intangible asset was not recognised, but that would have been had IFRS been applied and the intangible asset still exists at the date of transition.
- Consistent with the deemed cost principles for other assets and liabilities, such intangible assets should be measured on the basis that would be required if the acquiree were a first-time adopter at the same time as the acquirer, including any required accumulated amortisation reflecting the useful life of the intangible asset, irrespective of the period over which goodwill was amortised. Frequently the recognition and measurement criteria will not be met for intangible assets which are internally generated from the acquirees perspective because the acquiree will not have had at the time the original transaction took place reliable systems for accumulating such costs, or made and documented future economic benefits assessments. (These are specific IFRS requirements for the recognition of internally generated intangibles.) As such it is not expected that significant adjustments will result from this requirement.

- a contingency in relation to purchase consideration which is now reliably measurable and probable. This requirement is consistent with the requirements of AASB 1015 and therefore should not lead to the need for any adjustments.
- any impairment loss, following a compulsory impairment test performed in accordance with IAS 36 at the date of transition.

The measurement of minority interests and deferred tax follows from the measurement of other assets and liabilities. Therefore, where adjustments are required to recognise or derecognise assets or liabilities, the effect on minority interests or deferred tax should also be considered.

#### Example – Application of the Business Combinations Exemption

Entity B's first IFRS financial statements have a reporting date of 31 December 2005 and include comparative information for 2004 only. On 1 July 2001, entity B acquired 100% of subsidiary C. Under Australian GAAP, entity B:

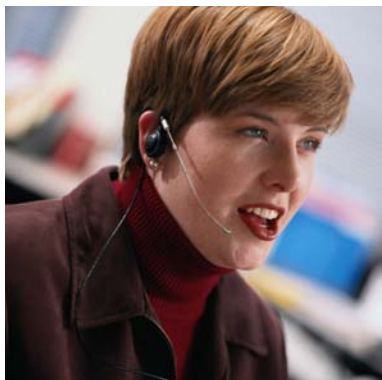
- classified the business combination as an acquisition by entity B.
- measured the assets acquired and liabilities assumed at the following amounts under Australian GAAP at 1 January 2004:
  - identifiable assets less liabilities for which IFRS require cost-based measurement at a date after the business combination: 200 (with a tax base of 150 and an applicable tax rate of 30 per cent).
  - defined benefit pension liability (for which the present value of the defined benefit obligation measured under IAS 19 is 130 and the fair value of plan assets is 100): nil (because Australian GAAP does not require recognition of such liabilities). The tax base of the pension liability is also nil.
  - goodwill: 180.
- did not, at the date of acquisition, recognise deferred tax arising from temporary differences associated with the identifiable assets acquired and liabilities assumed.

#### Application of Requirements

In its opening IFRS converged balance sheet, entity B:

- classifies the business combination as an acquisition by entity B even if the business combination would have qualified under IFRS as a reverse acquisition by subsidiary C or a uniting of interests.
- does not adjust the accumulated amortisation of goodwill. Entity B tests the goodwill for impairment under IAS 36 and recognises any resulting impairment loss, based on conditions that existed at the date of transition. If no impairment exists, the carrying amount of the goodwill remains at 180.
- for those net identifiable assets acquired for which IFRS require cost-based measurement at a date after the business combination, treats their carrying amount under Australian GAAP immediately after the business combination as their deemed cost at that date.
- does not restate the accumulated depreciation and amortisation of the net identifiable assets recognised, assuming the depreciation methods and rates under Australian GAAP do not result in amounts that differ materially from those required under IFRS. As such, the carrying amount of those assets in the opening IFRS converged balance sheet equals their carrying amount under Australian GAAP at the date of transition (200).





- if there is any indication that identifiable assets are impaired, tests those assets for impairment, based on conditions that existed at the date of transition.
- recognises the defined benefit pension liability, and measures it, at the present value of the defined benefit obligation (130) less the fair value of the plan assets (100), giving a carrying amount of 30, with a corresponding debit of 30 to retained earnings.
- recognises a net deferred tax liability of 6 (20 at 30%) arising from:
  - the taxable temporary difference of 50 (200 less 150) associated with the identifiable assets acquired and non-pension liabilities assumed, less
  - the deductible temporary difference of 30 (30 less nil) associated with the defined benefit pension liability.

The entity recognises the resulting increase in the deferred tax liability as a deduction from retained earnings.

#### Example – Business Combinations – Treatment of Intangible Assets

Entity H acquired a subsidiary before the date of transition. Under Australian GAAP, entity H:

- recognised goodwill, carrying value at date of transition: 100.
- recognised an intangible asset of the subsidiary that does not qualify for recognition as an asset under IAS 38. At the date of transition the intangible asset had a net carrying amount of 50.
- did not recognise a brand that had been internally generated by the subsidiary, that had a fair value of 50 at the date of acquisition.

#### Application of Requirements

In its opening IFRS converged balance sheet, entity H:

- does not recognise the intangible asset that does not qualify for recognition as an asset under IAS 38, transferring the balance of 50 to goodwill.
- does not recognise the brand as an intangible asset because it would not have qualified for capitalisation by the subsidiary under IAS 38 as it was internally generated.
- tests the goodwill for impairment under IAS 36 and recognises any impairment loss, based on conditions that existed at the date of transition.

It is also expected that goodwill will be adjusted for the write-off of any negative goodwill to opening retained earnings. This requirement was included in the original exposure draft but has not been included in the final Standard as it is dependent on the finalisation of ED 109. Assuming the proposal is introduced when the business combinations project is finalised, it is not likely to impact Australian entities as the equivalent of negative goodwill in Australia, discount on acquisition, has been incorporated into the initial measurement of non-monetary assets acquired and thus forms part of their deemed cost. The only time an Australian entity will have negative goodwill would be if any of the above adjustments in relation to intangible assets create it.

In cases where an entity was not consolidated under Australian GAAP, but is required to be under IFRS, for example in the case of certain special purpose entities, the subsidiary's assets and liabilities should be measured in the consolidated financial statements consistent with measurement in the subsidiary's own separate IFRS compliant financial statements. The deemed cost of goodwill, where the subsidiary was acquired in a business combination and business combinations have not been retrospectively restated, will equal the difference at the date of transition between:

- the parent's interest in the adjusted carrying amount; and
- the cost of the investment in the parent's separate financial statements.

This adjustment results in goodwill (or negative goodwill) effectively representing the net of original purchased goodwill and post-acquisition movements in equity. Where losses have been incurred post-acquisition, goodwill will be greater than original purchased goodwill, but will be subject to an impairment test.

The application of this exemption also applies to the consolidated financial statements of a parent entity that has not historically prepared consolidated financial statements. For example, the parent was a non-reporting entity and did not comply with AASB 1024 'Consolidated Accounts' but in the period beginning 1 January 2005 or later becomes a reporting entity.

Where the subsidiary was created, rather than acquired, no goodwill is recognised. The excess or deficit of the net assets of the subsidiary over the investment should be recognised against retained earnings.

#### 5.2.1.2. Restatement of Some or All Business Combinations

An entity may elect to restate either all historical business combinations or only those business combinations post a particular date. However an entity cannot elect to restate only selected business combinations. In such a case, the most recent version of IAS 22 'Business Combinations'/ED 109 should be applied. Superseded standards that may have existed at the date the actual business combination took place and the transitional provisions of IAS 22 should be ignored.



*Restatement of prior business combinations may result in the classification of the acquisition as a reverse acquisition. Reverse acquisition accounting is likely to lead to a lower goodwill value and therefore this may be a consideration in deciding whether to restate prior business combinations.*

### 5.2.2. Deemed Cost for Property, Plant and Equipment, Investment Property and Intangible Assets

On first-time adoption of IFRS, an entity may elect to treat the fair value of the following assets at the date of transition as their deemed cost at that date for subsequent measurement purposes:

- Property, plant and equipment;
- Investments property, where the cost method is adopted under IAS 40 'Investment Property'; or
- Intangible assets where the IAS 38 'Intangible Assets' recognition criteria are met (including reliable measurement at cost), and the intangible asset would normally qualify for revaluations, that is an active market exists.

This exemption may be applied irrespective of the previous basis of accounting adopted, and may be selectively applied for different assets within a class of assets.

Other deemed cost exemptions for the above assets are also available but their application is restricted depending on historical accounting policies. When an entity either:

- historically adopted the fair value basis of accounting under AASB 1041 'Revaluation of Non-Current Assets'; or
- on adoption of AASB 1041, created a 'deemed cost' based on a prior revaluation that was:
  - broadly comparable to fair value; or
  - performed through the use of a general or specific price index to a cost broadly comparable to cost or depreciated cost under IFRS;

the last revaluation may become 'deemed cost' under IFRS.

Note, not all 'deemed costs' created on the adoption of AASB 1041 will fall into the above exemption. Superseded AASB 1010 'Accounting for the Revaluation of Non-Current Assets' (issued 1993) did not specify the basis on which revaluations had to be performed and as such not all revaluations will fall into the above exemptions.



*Revaluations/'deemed costs' which were based on conservative (directors') valuations or included the effects of expected capital gains tax are not considered broadly comparable to fair value. The basis of all prior revaluations should be reviewed and an entity should confirm that the basis is consistent with fair value under IFRS, including excluding the effect of tax.*

Where the cost basis is adopted, the cost and accumulated depreciation of such assets will need to be determined under converged AASB Standards.

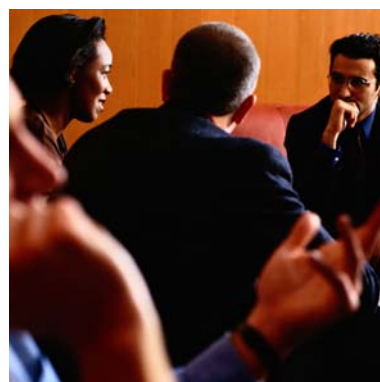
#### IFRS versus Australian GAAP Comparison

Adjustments, which may be required to bring Australian GAAP cost in line with IFRS, relating to property, plant and equipment and investment property include:

- Accounting for the cost of dismantling and removing an asset and restoring the site on which the asset was created;
- The treatment of the net proceeds from selling items produced in bringing the asset to that location;
- Recognition of revenues and expenses incidental to construction or development, but not necessary to bring the asset to its required location or working condition;
- Government grants, where the entity chooses to deduct grants from the carrying amount of the related asset; and
- Accounting for borrowing costs, refer section 4.3.6 for further details.

Refer section 4.3.1 for possible adjustments in relation to intangible assets.

Where the revaluation basis is adopted for property, plant and equipment and intangible assets, an entity is still required to determine what would have been the carrying amount under the cost basis in order to determine the balance that should be recognised in the asset revaluation reserve. (Note, the asset revaluation reserve under Australian GAAP will not equate to the asset revaluation reserve under IFRS where increments and decrements within a class of assets have been netted off against one another. This practice is not permissible under IFRS.) Where the amount cannot be determined the entity uses the deemed cost exemption and the asset revaluation reserve is (re)set to zero if deemed cost is the fair value at the date of transition, or the asset revaluation reserve is (re)set to another amount (being the difference between the deemed costs used and the fair value at the date of transition) if one of the other deemed cost exemptions, adjusted for accumulated depreciation, is adopted.



### Example

An entity has elected to adopt the revaluation basis for property on adoption of IFRS. Historically the entity had created 'deemed costs' on the adoption of AASB 1041 during the 2001 financial year. The date of transition is 1 January 2004.

	Carrying Value at Date of Transition	Original Cost less Accumulated Depreciation <sup>(4)</sup>	Fair Value at Date of Transition
Property 1 <sup>(1)</sup>	9,450	9,450	15,000
Property 2 <sup>(2)</sup>	8,100	6,235	10,000
Property 3 <sup>(2)</sup>	17,725	Unknown	25,000
Property 4 <sup>(3)</sup>	5,305	4,050	7,000

(1) Property 1 was acquired in 2003.

(2) The carrying value of properties 2 and 3 represents the deemed cost of the property at the date of adoption of AASB 1041, adjusted for subsequent depreciation. Deemed cost was based on an historical revaluation that was based on fair value at that time.

(3) The carrying value of property 4 represents the deemed cost of the property at the date of adoption of AASB 1041, adjusted for subsequent depreciation. Deemed cost was based on an historical revaluation that was not based on fair value at that time.

(4) Calculated in accordance with IFRS.

On the adoption of IFRS the asset revaluation reserve in relation to each property will be recognised as:

	Fair Value at Date of Transition	Deemed Cost	Asset Revaluation Reserve
Property 1	15,000	The entity may elect either the original cost, or the current fair value as the deemed cost on initial adoption.	0 or 5,550
Property 2	10,000	The entity may elect either the original cost, the AASB 1041 deemed cost, or the current fair value, as the deemed cost on initial adoption.	0, or 1,900 or 3,765
Property 3	25,000	The entity may elect either the AASB 1041 deemed cost, or the current fair value as the deemed cost on initial adoption.	0 or 7,275
Property 4	7,000	The entity may elect either the original cost, or the current fair value as the deemed cost on initial adoption. The AASB 1041 deemed cost is not acceptable because it is not broadly comparable to fair value.	0 or 2,950

Where the adjustment is not made to the asset revaluation reserve, the adjustment is be made to retained earnings. Therefore the choice of deemed cost impacts the split of equity and potentially the amount of profits that can easily be distributed.



Where the fair value basis is adopted for investment property, the carrying amount under the cost basis does not need to be determined, as changes in fair value are recognised in the income statement, therefore any adjustments at the date of transition should also be recognised in opening retained earnings.

### 5.2.3. Previous Event Driven Fair Value Measurements

On first-time adoption of IFRS, an entity may elect to carry forward deemed costs of assets and liabilities established under previous GAAP where such deemed costs were based on fair value at a particular date. Such deemed costs may have been created for the purpose of a privatisation or initial public offering in certain countries. Such an event drive measurement exemption is unlikely to be applicable in Australia because across the board fair value adjustments could only be created as part of acquisition accounting for consolidation purposes.

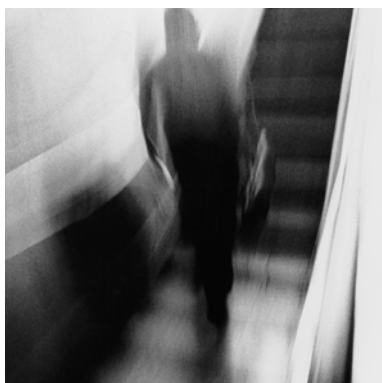
### 5.2.4. Employee Benefits – Defined Benefit Plans

IAS 19 'Employee Benefits' requires an asset or liability to be recognised in relation to defined benefit plans, for example, where they relate to superannuation or medical benefits. The measurement of such balances is dependent on an actuarial valuation. Over time actuarial gains and losses may offset and as such it may be argued that post-employment benefit obligations are best viewed as a range (or 'corridor') around the best estimate. As a result, IAS 19 has permitted actuarial gains and losses within a 10% 'corridor' of the best estimate not to be recognised. On initial adoption of IFRS, an entity may elect to recognise all cumulative actuarial gains and losses at the date of transition, effectively resetting the corridor to zero, even if the 'corridor approach' is to be adopted for subsequent actuarial gains and losses. If an entity has multiple defined benefit plans, this exemption must be applied consistently for all plans.

If this exemption is not adopted and full retrospective application of IAS 19 is performed, an entity would be required to determine actuarial gains and losses for each year since the inception of the plan in order to determine the net cumulative unrecognised gains or losses at the date of transition. In this case, the transitional provisions of IAS 19 cannot be applied.

*General practice in Australia is to not recognise either an asset or liability in relation to defined benefit plans.*





Note, the current IASB convergence project on employee benefits has considered a proposal requiring all actuarial gains and losses to be recognised immediately, that is the removal of the ‘corridor’. An exposure draft on these proposals is not due until quarter 4, 2003 with a Standard expected after quarter 1, 2004 and therefore unlikely to be applicable until post 2005. However, ED 115 ‘Request for Comment on IAS 19 Employee Benefits’ proposes to eliminate the ‘corridor’ when the converged AASB Standard, applicable for financial periods beginning on or after 1 January 2005, is issued. Therefore, the exemption within IFRS 1 will effectively become mandatory in Australia.

Irrespective of which method is adopted, it is recommended that actuarial valuations are obtained as the date of transition occurs, rather than in two years time at the first financial reporting date under IFRS 1, to ensure that the information necessary to perform the valuation is available. Refer section 5.1.3 regarding the need for estimates to reflect only those conditions that exist at the date of transition.

#### 5.2.5. Cumulative Translation Differences

An entity may elect at the date of transition to not identify cumulative foreign currency translation differences as a separate component of equity in relation to individual foreign operations, including in relation to associates, joint ventures and hedges of the net investment in these entities. In such circumstances, on the subsequent disposal of a foreign operation, cumulative foreign currency translation differences prior to the date of transition cannot be included in the calculation of any gains or losses on disposal. If applied, this exemption must be consistently applied for all foreign operations.

*Therefore, this exemption is an opportunity for entities with a loss recognised in their foreign currency translation reserve to write this off to opening retained earnings and start afresh. This is of significance assuming the current requirements of IAS 21 are maintained which allows the recycling of the foreign currency translation reserve on the disposal of such operations. This however is only likely to be a temporary loophole as the Income Statement Project is proposing to prohibit such recycling.*

#### IFRS versus Australian GAAP Comparison

The foreign currency translation reserve as determined under AASB 1012 ‘Foreign Currency Translation’ although similar, will vary to the calculation under IAS 21 ‘The Effects of Changes in Foreign Exchange Rates’:

- Parent entity financial statements: under IFRS exchange differences on items forming part of a net investment are recognised in reserves whereas they are recognised in the statement of financial performance under Australian GAAP.
- In consolidated financial statements where goodwill exists in relation to the foreign operation. The IASB Improvements Exposure Draft requires goodwill to be translated at the closing rate whereas under Australian GAAP it is translated at the exchange rate at the date of the acquisition.
- On the disposal of a foreign operation, IFRS requires that the amount of exchange differences previously deferred be recognised as income or expense in the period of the disposal. Australian GAAP does not allow such recycling of amounts accounted for in reserves.

### 5.2.6. Compound Financial Instruments

An entity that has issued compound financial instruments but the liability component is no longer outstanding at the date of transition, may elect not to identify the original equity component separately from retained earnings where this was not previously required under Australian GAAP. However, where the liability component is still outstanding on such instruments, the equity component will be required to be recognised.

This exemption may be applicable to:

- compound financial instruments issued prior to 1 January 1998 being the key date for segregation of the component parts of compound financial instruments in the transitional provisions of AASB 1033 'Presentation and Disclosure of Financial Instruments' where the liability component is not outstanding at the date of transition; and
- certain other compound financial instruments where some minor differences between AASB 1033 and IAS 32 'Financial Instruments: Disclosure and Presentation' (currently subject to improvements) may have caused some classification differences, and the liability component is no longer outstanding at the date of transition. (Refer section 4.3.3.)

### 5.2.7. First-Time Adoption Date Differs for Entities Within a Reporting Entity

A reporting entity and individual entities within the reporting entity may prepare their first IFRS compliant financial statements in different periods. For example, as a result of:

- the Australian entity being a subsidiary of an off-shore parent that has complied with IFRS before 1 January 2005; or
- a change in classification from small to large proprietary limited company; or
- an overseas subsidiary, associate or joint venture having complied with IFRS before 1 January 2005 for overseas reporting purposes.



If a **subsidiary becomes a first-time adopter later than its parent**, at the time the subsidiary becomes a first-time adopter, the subsidiary can measure its assets and liabilities at either:

- Their carrying amounts in the parent's consolidated IFRS financial statements, before considering the effect of business combinations or consolidation procedures; or
- Their carrying amounts determined in accordance with IFRSs based on the subsidiary's date of transition. That is in accordance with the requirements of IFRS 1.

Note, if the second alternative is adopted a subsidiary will need to keep two sets of accounting records based on different dates of transition to IFRS. This exemption applies equally to an associate or joint venture where the entity that has significant influence or joint control over it adopts IFRS earlier.

If an **entity becomes a first-time adopter later than its subsidiary, associate or joint venture**, in the entity's consolidated financial statements the subsidiary's, associate's or joint venture's assets and liabilities may not be restated and must be measured consistently with their historical IFRS financial statements, after considering the effect of business combinations and consolidation or equity accounting adjustments.

A final exemption exists where a parent becomes a first-time adopter for its separate financial statements earlier or later than for its consolidated financial statements. This exemption is likely to apply in Australia only where the parent financial statements are prepared earlier than the consolidated financial statements, for example where a non-reporting entity becomes a reporting entity and previously prepared a non-consolidated special purpose financial report. In such a case, the consolidated entity's date of transition is the opening comparative period, but the parent entity balances included in the opening balance sheet will be measured equivalent to their single entity financial statements. The reverse cannot occur in the Australian environment because if consolidated financial statements are prepared, parent entity financial statements will always be prepared.

## 6. Disclosures

### 6.1. Comparative Information

As noted in section 3.2, comparative information for at least one financial year needs to be restated as though the IFRS converged AASB Standards have always been applied. Any additional comparative information not complying with IFRS must be clearly labelled as such and disclosure should be made of the main adjustments (no quantification required) that would be required to make the information IFRS compliant.

Historical summaries of selected data included in the financial report do not need to comply with the recognition and measurement requirements of IFRS. However, the nature of the main adjustments (no quantification required) that would be required to make the information IFRS compliant must be disclosed.

### 6.2. Explanation of Transition to IFRS

In both the first IFRS half-year and annual financial reports, an entity must explain how the transition to IFRS converged AASB Standards affected the entity's reported financial position, financial performance and cash flows. To achieve this an entity should include:

- In the annual and half-year financial report:
  - A reconciliation of the entity's equity reported in the previous annual financial report to that reported in the first IFRS compliant financial report as at:
    - The date of transition; and
    - The end of the latest annual comparative period<sup>4</sup>.
  - A reconciliation of the entity's profit or loss reported in the latest annual comparative period to that reported in the first IFRS compliant financial report.
  - An explanation of the material adjustments to the cash flow statement.

When included in the half-year financial report, the above information may be provided through a cross reference to another published document that includes these reconciliations.

- In the half-year financial report the following additional information should be presented:
  - A reconciliation of the entity's equity reported in the previous half-year financial report to that reported in the first IFRS compliant half-year financial report.

*IFRS 1 does not provide exemptions from the presentation and disclosure requirements of other Standards but provides guidance on certain principles, and requires some additional disclosure in the first year of adoption to explain the transition process and the adjustments that have been made. Note, the disclosure requirements of IAS 8 'Accounting Policies, Changes in Accounting Estimates and Errors' in relation to changes in accounting policies does not apply on first-time adoption.*



<sup>4</sup> IFRS 1 refers to the end of the latest period presented in the entity's most recent annual financial statements prepared under Australian GAAP. Given the annual reporting requirements that exist in Australia this will in practice be the latest annual comparative period, but may be another period, or not at all, where a financial report was not required to be prepared in the prior period.



- A reconciliation of the entity's profit or loss reported in the previous half-year financial report to that reported in the first IFRS compliant half-year financial report.

These disclosures should provide sufficient detail to enable users to understand the material adjustments to the balance sheet and income statement, and shall distinguish changes in accounting policy from corrections of errors, where appropriate.

The format of these disclosures may take a number of forms, including either a movement schedule of equity identifying each adjusting item or a comparison of an Australian GAAP versus IFRS balance sheet and profit and loss. In both cases, additional notes will most likely be required to further explain the adjustments. (Deloitte will develop proforma disclosures when revisions to AASB 1018 'Statement of Financial Performance' and AASB 1040 'Statement of Financial Position' are finalised.)

### **6.3. Other Disclosures**

#### **6.3.1. Use of Fair Value as Deemed Cost**

If an entity uses fair value at the date of transition as deemed cost, as explained in section 5.2.2, for each line item affected in the opening IFRS balance sheet, the entity must disclose:

- The aggregate of those fair values; and
- The aggregate adjustment to the carrying amount previously reported under Australian GAAP.

#### **6.3.2. Impairment Losses**

If impairment losses were recognised or reversed in preparing the opening IFRS balance sheet, the disclosures that current IAS 36 'Impairment of Assets' would have required if the entity had recognised these impairment losses or reversals in a normal reporting period are required. These include:

- The amount of impairment losses or reversals recognised in aggregate and by segment;
- The events or circumstances that lead to the recognition or reversals of the impairment losses and the asset or cash-generating unit involved; and
- The basis on which recoverable amount has been determined.

## 7. Other Resources

The following resources may be useful for further research on first-time adoption of IFRS.

### 7.1. Accounting Pronouncements

#### 7.1.1. IASB Pronouncements

The following information can be purchased from the IASB. Refer their web site: [www.iasb.org.uk](http://www.iasb.org.uk):

- IFRS 1 'First-Time of Adoption of International Financial Reporting Standards'
- Basis for Conclusions on IFRS 1 First-Time of Adoption of International Financial Reporting Standards
- Guidance on Implementing IFRS 1 First-Time of Adoption of International Financial Reporting Standards

#### 7.1.2. Related Information

The following information can be located on the AASB web site: [www.aasb.com.au](http://www.aasb.com.au):

- AASB Media Release 'AASB Welcomes Issue of IASB Standard', 19 June 2003
- IASB Press Release 'IASB Issues a Standard on Transition to International Financial Reporting Standards', 19 June 2003

### 7.2. Deloitte Information

The following information can be located on the Deloitte web site: [www.deloitte.com.au](http://www.deloitte.com.au):

- Accounting Alert 2003-01 'Australian Accounting Standards Set for Major Overhaul'
- Accounting Alert 2002/16 'Australia's Transition to International Accounting Standards'
- Accounting Alert 2002/12 'AASB Issues Exposure Draft on First-Time Application of International Financial Reporting Standards'
- Accounting Alert 2002/09 'Australia Set to Adopt International Accounting Standards by 2005'
- Publication 'International Financial Reporting Standards Healthcheck 2003'
- Publication 'Differences Between Australian GAAP and IFRS and the Future Direction of Accounting Standards'



### 7.3. Our Experts

For assistance in applying the first-time adoption principles, please contact one of our experts:

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