

IFRS 1, FIRST-TIME ADOPTION OF INTERNATIONAL FINANCIAL REPORTING STANDARDS QUESTIONS AND ANSWERS

On 19 June 2003, the International Accounting Standards Board issued IFRS 1, First-Time Adoption of International Financial Reporting Standards. IFRS 1 sets out the procedures that an entity must follow when it adopts IFRS for the first time as the basis for preparing its general purpose financial statements. This newsletter summarises the main provisions of IFRS 1 and identifies some examples of applying them.

Who is a first-time adopter?

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.

Can an entity be a first-time adopter if, in the preceding year, it has prepared IFRS financial statements for internal management use?

Yes, as long as those IFRS financial statements were not given to owners or external parties such as investors or creditors. If a set of IFRS statements was, for any reason, given to an external party in the preceding year, then the entity will already be considered to be on IFRS and IFRS 1 does not apply.

What if, last year, an entity said it complied with selected, but not all, IFRS, or it included in its previous -GAAP financial statements a reconciliation of selected figures to IFRS figures?

It can still qualify as a first-time adopter.

When does IFRS 1 take effect?

IFRS 1 applies if an entity's first IFRS financial statements are for a period beginning on or after 1 January 2004. Earlier application is encouraged.

If an entity adopts IFRS for the first time in its annual financial statements for the year ended 31 December 2005, what is it required to do?

1. **Accounting policies.** The entity should select its accounting policies based on IFRS in force at 31 December 2005. (The exposure draft that preceded IFRS 1 had proposed that an entity could use the IFRS that were in force during prior periods, as if the entity had always used IFRS. That option is not included in the final standard.)
2. **IFRS reporting periods.** The entity should prepare at least 2005 and 2004 financial statements and restate retrospectively the opening balance sheet (beginning of the first period for which full comparative financial statements are presented) by applying the IFRS in force at 31 December 2005.
 - a. Since IAS 1 requires that at least one year of comparative prior period financial information be presented, the opening balance sheet will be 1 January 2004 if not earlier.
 - b. If a 31 December 2005 adopter reports selected financial data (but not full financial statements) on an IFRS basis for periods prior to 2004, in addition to full financial statements for 2004 and 2005, that does not change the fact that its opening IFRS balance sheet is as of 1 January 2004.

What adjustments are required to move from previous GAAP to IFRS?

1. **Derecognition of some old assets and liabilities.** The entity should eliminate previous-GAAP assets and liabilities from the opening balance sheet if they do not qualify for recognition under IFRS. For example:
 - a. IAS 38 does not permit recognising expenditure on any of the following as an intangible asset: research; start-up, pre-operating, and pre-opening costs; training; advertising and promotion; and moving and relocation. If previous GAAP recognised these as assets, they are eliminated in the opening IFRS balance sheet.
 - b. If previous GAAP had allowed accrual of liabilities for "general reserves", restructurings, future operating

losses, or major overhauls that do not meet the conditions for recognition as a provision under IAS 37, these are eliminated in the opening IFRS balance sheet.

- c. If previous GAAP had allowed recognition of reimbursements or contingent assets that are not virtually certain, these are eliminated in the opening IFRS balance sheet.
2. **Recognition of some new assets and liabilities.** Conversely, the entity should recognise all assets and liabilities required to be recognised by IFRS even if they were never recognised under previous GAAP. For example:
 - a. IAS 39 requires recognition of all derivative financial assets and liabilities, including embedded derivatives. These were not recognised under many local GAAPs.
 - b. IAS 19 requires an employer to recognise its liabilities under defined benefit plans. These are not just pension liabilities but also obligations for medical and life insurance, vacations, termination benefits, and deferred compensation. In the case of “over-funded” plans, this would be a defined benefit asset.
 - c. IAS 37 requires recognition of provisions as liabilities. Examples could include obligations for onerous contracts, restructurings, decommissioning, site restoration, warranties, guarantees, and litigation.
 - d. Deferred tax assets and liabilities would be recognised in conformity with IAS 12.
 3. **Reclassification.** Reclassify previous-GAAP opening balance sheet items into the appropriate IFRS classification. Examples:
 - a. IAS 10 does not permit classifying dividends declared or proposed after the balance sheet date as a liability at the balance sheet date. In the opening IFRS balance sheet these would be reclassified into retained earnings.
 - b. If previous GAAP had allowed treasury shares (an entity’s own shares that it had purchased) to be reported as an asset, it would be reclassified as a component of equity under IFRS.
 - c. Items classified as identifiable intangible assets in a business combination accounted for under the previous GAAP may be required to be classified as goodwill under IAS 22 because they do not meet the definition of an intangible asset under IAS 38. The converse may also be true in some cases. These must be reclassified.
 - d. IAS 32 has principles for classifying items as financial liabilities or equity. Thus mandatorily redeemable preferred shares and puttable shares that may have been classified as equity under previous GAAP would be reclassified as liabilities in the opening IFRS balance sheet.
 - Note that IFRS 1 makes an exception from the “split-accounting” provisions of IAS 32. If the liability component of a compound financial instrument is no longer outstanding at the date of the opening IFRS balance sheet, the entity is not required to reclassify out of retained earnings and into other equity the original equity component of the compound instrument.
 - e. The reclassification principle would apply for the purpose of defining reportable segments under IAS 14.
 - f. The scope of consolidation might change depending on the consistency of the previous GAAP requirements with those in IAS 27. In some cases, IFRS will require consolidated financial statements where they were not required before.
 4. **Measurement.** The general measurement principle – there are several significant exceptions noted below – is to apply IFRS in measuring all recognised assets and liabilities. Therefore, if an entity adopts IFRS for the first time in its annual financial statements for the year ended 31 December 2005, in general it would use the measurement principles in IFRS in force at 31 December 2005.
 5. **Adjustments required to move from previous GAAP to IFRS at the time of first-time adoption.** These should be recognised directly in retained earnings or other appropriate category of equity at the date of transition to IFRS.

What are the exceptions to the basic measurement principle in IFRS 1?

1. **Optional exceptions.** There are some important exceptions to the general restatement and measurement principles set out above. The following exceptions are individually optional, not mandatory:

Business combinations that occurred before opening balance sheet date

- a. An entity may keep the original previous-GAAP accounting, that is, not restate:
 - previous mergers or goodwill written-off from reserves;
 - the carrying amounts of assets and liabilities recognised at the date of acquisition or merger;
 - how goodwill was initially determined (do not adjust the purchase price allocation on acquisition).
- b. However, should it wish to do so, an entity can elect to restate all business combinations starting from a date

it selects prior to the opening balance sheet date.

- c. In all cases, the entity must make an initial IAS 36 impairment test of any remaining goodwill in the opening IFRS balance sheet, after reclassifying, as appropriate, previous GAAP intangibles to goodwill.

Property, plant, and equipment, intangible assets, and investment property carried under the cost model

- a. These assets may be measured at their fair value at the opening IFRS balance sheet date (this option applies to intangible assets only if an active market exists). Fair value becomes the “deemed cost” going forward under the IFRS cost model. “Deemed cost” is a surrogate for an actual cost measurement.
- b. If, before the date of its first IFRS balance sheet, the entity had revalued any of these assets under its previous GAAP either to fair value or to a price-index-adjusted cost, that previous GAAP revalued amount at the date of the revaluation can become the deemed cost of the asset under IFRS.
- c. If, before the date of its first IFRS balance sheet, the entity had made a one-time revaluation of assets or liabilities to fair value because of a privatisation or initial public offering, and the revalued amount became deemed cost under the previous GAAP, that amount (adjusted for any subsequent depreciation, amortisation, and impairment) would continue to be deemed cost after the initial adoption of IFRS.

IAS 19 – Employee benefits: actuarial gains and losses

An entity may elect to recognise all cumulative actuarial gains and losses for all defined benefit plans at the opening IFRS balance sheet date (that is, reset any corridor recognised under previous GAAP to zero), even if it elects to use the IAS 19 corridor approach for actuarial gains and losses that arise after first-time adoption of IFRS. If an entity does not elect to apply this exemption, it must restate all defined benefit plans under IAS 19 since the inception of those plans (which may differ from the effective date of IAS 19).

IAS 21 – Accumulated translation reserves

An entity may elect to recognise all translation adjustments arising on the translation of the financial statements of foreign entities in accumulated profits or losses at the opening IFRS balance sheet date (that is, reset the translation reserve included in equity under previous GAAP to zero). If the entity elects this exemption, the gain or loss on subsequent disposal of the foreign entity will be adjusted only by those accumulated translation adjustments arising after the opening IFRS balance sheet date. If the entity does not elect to apply this exemption, it must restate the translation reserve for all foreign entities since they were acquired or created.

2. **Mandatory exceptions.** There are also three important exceptions to the general restatement and measurement principles set out above that are mandatory, not optional. These are:

IAS 39 – Derecognition of financial instruments

A first-time adopter is not permitted to recognise financial assets or financial liabilities that had been derecognised under its previous GAAP in a financial year beginning before 1 January 2001 (the effective date of IAS 39). This is consistent with the transition provision in IAS 39.172(a). However, if a special purpose entity (SPE) was used to effect the derecognition of financial instruments and the SPE is controlled at the opening IFRS balance sheet date, the SPE must be consolidated.

IAS 39 – Hedge accounting

The conditions in IAS 39.122-152 for a hedging relationship that qualifies for hedge accounting are applied as of the opening IFRS balance sheet date. The hedge accounting practices, if any, that were used in periods prior to the opening IFRS balance sheet may not be retrospectively changed. This is consistent with the transition provision in IAS 39.172(b). Some adjustments may be needed to take account of the existing hedging relationships under previous GAAP at the opening balance sheet date.

Information to be used in preparing IFRS estimates retrospectively

In preparing IFRS estimates retrospectively, the entity must use the inputs and assumptions that had been used to determine previous GAAP estimates in prior periods, provided that those inputs and assumptions are consistent with IFRS. The entity is not permitted to use information that became available only after the previous GAAP estimates were made except to correct an error.

How will the change to IFRS affect an entity’s ongoing disclosures?

For many entities, new areas of disclosure will be added that were not requirements under the previous GAAP (perhaps segment information, earnings per share, discontinuing operations, contingencies, and fair values of all financial instruments) and disclosures that had been required under previous GAAP will be broadened (perhaps related party disclosures).

IAS 1 only requires one year of full comparative financial statements. If a first-time adopter wants to disclose selected financial information for periods before the date of the opening IFRS balance sheet, is it required to conform that information to IFRS as well?

No. Conforming that earlier selected financial information to IFRS is optional. If the entity elects to present the earlier selected financial information based on its previous GAAP rather than IFRS, it must prominently label that earlier information as not complying with IFRS and, further, it must disclose the nature of the main adjustments that would make that information comply with IFRS. This latter disclosure is narrative and not necessarily quantified.

Of course, if the entity elects to present more than one year of full comparative prior period financial statements at the time of its transition to IFRS, that will change the date of the opening IFRS balance sheet.

What disclosures is a first-time adopter required to make in connection with the switch to IFRS?

IFRS 1 requires disclosures that explain how the transition from previous GAAP to IFRS affected the entity's reported financial position, financial performance, and cash flows. This includes:

1. Reconciliations of equity reported under previous GAAP to equity under IFRS both (a) at the date of the opening IFRS balance sheet and (b) the end of the last annual period reported under the previous GAAP. For an entity adopting IFRS for the first time in its 31 December 2005 financial statements, the reconciliations would be as of 1 January 2004 and 31 December 2004.
2. Reconciliations of profit or loss for the last annual period reported under the previous GAAP to profit or loss under IFRS for the same period.
3. Explanation of material adjustments (including error corrections and impairment losses) that were made, in adopting IFRS for the first time, to the balance sheet, income statement, and cash flow statement.
4. Appropriate explanations if the entity has availed itself of any of the specific recognition and measurement exemptions permitted under IFRS 1 – for instance, if it used fair values as deemed cost.

If an entity is going to adopt IFRS for the first time in its annual financial statements for the year ended 31 December 2005, is any disclosure required in its financial statements prior to the 31 December 2005 statements?

Yes, but only if the entity presents an interim financial report that complies with IAS 34. Explanatory information and a reconciliation are required in the interim report that immediately precedes the first set of IFRS annual financial statements. The information includes changes in accounting policies compared to those under previous local GAAP.

A parent or investor may become a first-time adopter earlier than or later than its subsidiary, associate, or joint venture investee. In these cases, how is IFRS 1 applied?

1. If the subsidiary has adopted IFRS in its entity-only financial statements before the group to which it belongs adopts IFRS for the consolidated financial statements, then the subsidiary's first-time adoption date is still the date at which it adopted IFRS for the first-time, not that of the group. However, the group must use the IFRS measurements of the subsidiary's assets and liabilities for its first IFRS financial statements except for adjustments relating to the business combinations exemption and to conform group accounting policies.
2. If the group adopts IFRS before the subsidiary adopts IFRS in its entity-only financial statements, then the subsidiary has an option either (a) to elect that the group date of IFRS adoption is its transition date or (b) to first-time adopt in its entity-only financial statements.
3. If the group adopts IFRS before the parent adopts IFRS in its entity-only financial statements, then the parent's first-time adoption date is the date at which the group adopted IFRS for the first time.
4. If the group adopts IFRS before its associate or joint venture adopts IFRS in its entity-only financial statements, then the associate or joint venture should have the option to elect that either the group date of IFRS adoption is its transition date or to first-time adopt in its entity-only financial statements.

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