IFRS Link
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A period of calm for international standards

Towards the end of 2003, the International Accounting Standards Board ('IASB') indicated its intention to institute a 'period of calm' with respect to the application date for any new standards. The cut off date was 31st March 2004 and any standard issued after that date will have a first time application date beyond 1st January 2005. The IASB still has a large number of projects to revise existing standards and issue new ones. Therefore, we will continue to see new IFRS, but with later application dates. March, however, saw a period of great activity for the IASB with four new standards being issued.

IFRS 2 - Share-based payments
IFRS 3 - Business combinations
IFRS 4 - Insurance contracts
IFRS 5 Non-current assets held for disposal and discontinued operations

In addition, there was a further exposure draft of IAS 39 'Financial instruments - recognition and measurement'

In this edition of IFRS Link we are looking at two of the latest standards IFRS 2 and IFRS 5, which both introduce accounting concepts that will be new to the majority of the preparers and users of financial statements. In addition we consider the revised IAS 32 - 'Financial Instruments: presentation and disclosure'.

IFRS 2 - Share-based payments

Historically, in most countries there have been few accounting requirements in respect of share-based payments. IFRS 2 therefore represents a major change for most preparers and users of financial statements. Whilst the standard has an application date for periods beginning on or after 1st January 2005, its provisions apply to all share-based payments granted after 7th November 2002 which have not vested at the date of first application.

Whilst dealing with all circumstances where goods and services are paid for using financial instruments (most usually shares or share options), by far the biggest impact is on companies who use share options as part of their remuneration packages for directors and employees. In the very simplest of terms the standard requires a charge to the profit and loss account to reflect the 'cost' of those options. There are no exceptions to the standard and it applies equally to both quoted and unquoted companies.

Three types of share-based payment are identified.

Equity-settled share-based payments

These are probably the most usual arrangements and will include nearly all share options granted to directors and employees.

The general principle adopted by the standard is that share-based payments should be accounted for based on their 'fair value'. The basis of determination of that fair value varies dependent on the type of goods or services to which the payment relates. Fair value should be measured by reference to the value of the goods and services received, unless this cannot be measured reliably. Where reliable measurement of the goods or services is not possible, fair value should be measured by reference to the fair value of the financial instrument. The standard takes the view that the fair value of the services of employees cannot be measured reliably and, therefore, such share-based payments should be calculated by reference to the fair value of the financial instrument. Therefore, for a company granting share options to its employees or directors the amount to be included in the accounts will be calculated by reference to the value of the option.

In the (rare) circumstances where there is a market price for share options, this value can be used. However, in most cases the fair value will only be capable of determination through the use of some form of option pricing model. Those companies who will be affected by the standard will need to start to consider how best to obtain the necessary valuations.

Once the fair value has been determined, it will usually be an expense in the profit and loss account unless it happens to meet the definition of an asset (for example where it is directly related to the construction of an asset). Where the shares or options vest immediately it can usually be presumed that the services to which they relate have been rendered and the expense should be recorded immediately. If, however, they vest in the future then it is assumed that the services are to be received in the future. In these circumstances the charge should be provided over the period to vesting based on an annual estimate of the number of shares expected to vest.

Cash-settled share-based payments

Share appreciation rights are one example of a cash-settled share-based payment. Under these arrangements employees become entitled to a future cash payment based on the increase in the company's share price from a specified level over a period of time. The amount to be included in the accounts is calculated by making an estimate of the amount that will be paid to the employees based on the movement in share price to the financial year end. The charge is made over the period to which the services relate.

Share-based payment transactions with cash alternatives

The accounting treatment in these cases will depend upon whether it is the 'counterparty' (for example the employee) or the company which has the option of choosing the method of settlement.

Where the counterparty has the choice, the standard treats this as a 'compound' instrument with both a debt and equity element. The amount attributable to the debt element should be accounted for as a cash-settled share-based payment and the equity element as an equity-settled share-based payment.

Where it is the company that has the option of settlement, if there is an effective obligation to settle in cash (for example if it is the company's usual practice to do so) it should be accounted for as cash-settled. Otherwise it should be accounted for as equity-settled.

IFRS 5 - Non-current assets held for sale and discontinued operations

IFRS 5 is the first international standard to be produced as part of a convergence project between international standards and US standards and it closely follows the principles of the US accounting standard FAS 144 "Accounting for the impairment or disposal of long-lived assets". Unless preparers or users of financial statements are familiar with US GAAP, IFRS 5 will introduce both new concepts and new balance sheet classifications.

Non-current assets held for sale

IFRS 5 introduces a new classification into the balance sheet of IFRS compliant financial statements - 'assets held for sale'. This term may be applied to a single asset such as a building or to a group of assets and associated liabilities - a 'disposal group'. The latter would include a subsidiary which has been identified for disposal.

The criteria for classifying as held for sale are strict and require the asset to be available for immediate sale and for that sale to be highly probable - namely:

- the appropriate level of management must be committed to plan to sell the asset or disposal group; and
- an active programme to locate a buyer and complete the plan must have been initiated.

Further:

- The asset or disposal group must be being actively marketed for sale at a price that is reasonable in relation to its current fair value.
- In addition, the sale should be expected to qualify as a completed sale within twelve months of the date of classification as held for sale.

When a non-current asset or disposal group is first identified as held for sale it should be measured in accordance with existing accounting standards which includes taking account of any impairment. The asset should then be re-measured at the lower of its carrying value and fair value less costs to sell. No depreciation can be charged on such assets.

Non-current assets and the assets of a disposal group identified for sale are required to be disclosed separately on the face of the balance sheet. The liabilities of a disposal group are also required to be disclosed separately within liabilities and cannot be offset against any associated assets.

Discontinued operations

IFRS 5 also deals with disclosure of discontinued operations and will replace the current standard, IAS 35. Disclosure is required in respect of a "component" of an entity which has either been sold in the financial period or is identified as available for sale. A component is a separately identifiable operation or cash flow stream that can be clearly distinguished, both operationally and for financial reporting purposes, from the rest of the entity. To be recognised as discontinued it also needs to represent a separate major line of business or geographical area or be a subsidiary acquired exclusively with a view to resale.

The post-tax profits and losses of a discontinued operation are presented as one line within the profit and loss account, with further analysis of revenue, expenses and pre-tax profits either in the notes or alternatively on the face of the profit and loss account.

IAS 32 - Financial instruments: disclosure and presentation

IAS 32 is the less controversial of the two international accounting standards dealing with financial instruments. However, it is still likely to result in significant changes in the financial statements of a number of companies. It should also be remembered that the term 'financial instrument' is widely defined and includes not only complex instruments such as derivatives, but also 'every day' items such as loans and share capital.

Presentation

IAS 32 draws a distinction between financial liabilities and equity, with the latter being very tightly defined. As a consequence, financial instruments are classified and presented based on their substance rather than their legal form. Whilst some financial instruments may have the legal form of equity, they could, in substance, be liabilities. For example, most redeemable preference shares are required to be accounted for as liabilities not as part of equity.

The accounting treatment of interest, dividends, losses and gains follows the treatment afforded the financial instrument in the balance sheet. Therefore, in the case of redeemable preference shares accounted for as liabilities, any dividends paid on those shares will be included within interest expense.

Compound financial instruments such as convertible debt are required to be split into their separate components - namely between liabilities and equity. An example would be a bond that is convertible into a fixed number of ordinary shares. Application of the standard results in the reporting entity recording two separate items - a financial liability and an equity instrument. The liability element is determined first by measuring the fair value of a similar instrument without the conversion option. The equity element is then calculated by deducting the liability from the fair value of the whole instrument.

Disclosure

All entities are required to make disclosures intended to enhance an understanding of the impact of financial instruments on its financial position, performance and cash flows.

The standard does not prescribe either the format of the information to be disclosed or where disclosures should be made. The requirements are probably going to be best met through a combination of narrative descriptions and financial data, but should include the following:

- A description of risk management policies and hedging activities
- Details of the terms of individual financial instruments
- The accounting policies applied
- Details about exposure to interest rate risk for each class of financial asset and liability
- Information about exposure to credit risk for each class of financial asset and other credit exposures.

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