

IFRS *Link*

September 2003

Issue Number 1

The International Accounting Standards Board's programme to both improve a number of its existing standards and issue standards on new topics is gathering pace. A number of new standards are expected in the next six months and as many national standards setting bodies are committed to the convergence with international standards, the challenge for both preparers and their advisers is significant.

This is the first edition of a new newsletter which aims to keep you informed of developments in International Financial Reporting Standards. It is fitting that in our first edition we will be discussing the first International Financial Reporting Standard issued by the IASB together with some of the more important projects in the pipeline and the timetable for change.

IFRS 1 'First time application of International Financial Reporting Standards'

The first new International Financial Reporting Standard deals (appropriately) with the steps companies will need to take in preparing their first set of fully IFRS compliant financial statements. It will also apply to any interim financial reports issued by that entity in the period covered by those financial statements.

How many periods will need to be converted?

Most jurisdictions require financial statements to include at least one year's comparatives. This means that most entities will, on first adoption need to prepare three years' worth of information in accordance with IFRS - the opening balance sheet for the comparative period, the comparative period and the current period.

Which IFRS should be applied?

The IFRS to be used are those which are in effect at the date of transition. A new IFRS which is in issue but not yet mandatory may be adopted early.

Are there any exemptions?

The IFRS does permit certain limited exemptions from the requirements of some

international standards in order to ease the process of transition.

· Business combinations

A first-time adopter need not apply IAS 22 'Business Combinations' retrospectively. Should it restate any business combination to comply with IAS 22, then all later business combinations must also be restated.

Where a first-time adopter has accounted for a business combination as an acquisition and recognised an item as an intangible asset which does not qualify as an intangible asset under IAS 38 'Intangible Assets' that item should be reclassified as goodwill.

The carrying amount of goodwill in the opening IFRS balance sheet should be its carrying value under previous GAAP adjusted for any intangible asset that does not meet the IAS definition and additional evidence that is now available with respect to any contingent purchase consideration. In addition, irrespective of whether there is any indication of impairment, IAS 36 'Impairment of Assets' should be applied to test the carrying value of goodwill at the date of transition.

Where previous GAAP required or permitted goodwill to be disclosed as a deduction from equity, it should not be recognised in the opening balance sheet, nor should the goodwill be transferred to the income statement on disposal of the subsidiary.

If under previous GAAP, the first-time adopter did not consolidate a subsidiary, but IFRS would require it to be consolidated the accounting treatment is as follows. The carrying amounts of the subsidiary's assets and liabilities should be adjusted to those required by IFRS. The deemed goodwill will equal the difference between the parent's cost of investment in the subsidiary and its interest in those assets and liabilities.

· Valuation of property, plant and equipment

An entity may elect to measure an item of property, plant or equipment at its

fair value at the date of transition and treat that fair value as cost.

A previous revaluation may be used as deemed cost, if that revaluation is broadly comparable to either fair value or cost or depreciated cost under IFRS, adjusted to reflect changes in a general or specific price index.

· Employee benefits

IAS 19 'Employee benefits' allows an entity to elect to use a 'corridor' approach which results in some actuarial gains and losses going unrecognised. It is accepted that retrospective application of this requirement would pose many practical problems for preparers of accounts. A first-time adopter may elect to recognise all cumulative actuarial gains and losses at the date of transition to IFRS, even if it uses the corridor approach for later actuarial gains and losses. If this approach is adopted it must be applied to all pension plans.

· Cumulative translation differences

IAS 21 'The Effects of Changes in Foreign Exchange Rates' requires an entity to classify some translation differences as a separate component of equity and on disposal of a foreign operation, to transfer the cumulative translation difference for that foreign operation to the income statement as part of the gain or loss on disposal.

A first-time adopter need not comply with these requirements for cumulative translation differences that existed at the date of transition to IFRS. Where a first-time adopter uses this exemption the cumulative translation differences for all foreign operations are deemed to be zero and the gain or loss on subsequent disposal shall exclude translation differences arising before the date of transition.

· Compound financial instruments

IAS 32 'Financial instruments: Disclosure and Presentation' requires a compound financial instrument (e.g. certain types of convertible debt) to be

split at inception into liability and equity components. If the liability component is no longer outstanding, retrospective application of IAS 32 involves separating two portions of equity. The first is in retained earnings and represents cumulative interest accreted on the liability component and the second represents the original equity component. A first-time adopter need not separate the two components if the liability component is no longer outstanding.

Assets and liabilities of subsidiaries, associates and joint ventures

If a subsidiary becomes a first-time adopter later than its parent, the subsidiary should, in its own financial statements, measure its assets and liabilities at either:

- the carrying amounts that would be included in the parent's consolidated financial statements, based on the parent's date of transition to IFRS, if no adjustments were made for consolidation procedures or the effect of the business combination in which the subsidiary was acquired; or
- the carrying amounts required by first-time application, based on the subsidiary's date of transition to IFRS.

If an entity becomes a first-time adopter later than its subsidiary it should, in its consolidated financial statements, measure the assets and liabilities at the same carrying amount as in the separate financial statements of the subsidiary, after adjusting for consolidation adjustments.

Exceptions to retrospective application

Retrospective application of certain aspects of IFRS relating to the following areas is prohibited.

Derecognition of financial assets and financial liabilities

A first time adopter will be required to apply the derecognition requirements of IAS 39 'Financial instruments: recognition and measurement' prospectively from the effective date of IAS 39 (periods beginning on or after 1st January 2001). The first time adopter will, however, be required to consolidate all special purpose entities (SPEs) that it controls at the date of transition, even if they existed at the date of transition or held financial assets or financial liabilities that were derecognised under previous GAAP.

Hedge accounting

An entity cannot reflect in its opening IFRS balance sheet a hedging relationship of a type that does not qualify under IAS 39.

Estimates

The estimates made under IFRSs at the date of transition should be consistent with the same estimates made at the same date under previous GAAP, unless there is objective evidence that the estimates were in error. Where estimates are required on transition that were not required under previous GAAP, those estimates should reflect conditions that existed at the date of transition.

What happens to any differences arising on transition?

To the extent that differences between International Standards and local GAAP result in adjustments to previous periods these should be recognised directly in retained earnings (or where appropriate another category of equity).

What disclosure is required in the first year?

In the first year of transition to International Standards, certain additional disclosures are required to show how the transition from previous GAAP to IFRS has affected the reported financial position, performance and cash flows.

This information should be presented by including reconciliations within the first set of accounts following transition.

Exposure drafts in issue

There are a number of exposure drafts currently in issue and the timetable for these to be converted into IFRS is set out at the back of this bulletin. A number of these will result in significant changes to financial reporting and, whilst it is not possible to cover them in detail here, some of the key points to note are discussed below.

Improvements to International Accounting Standards

Improvements to 12 existing standards was part of the initial agenda of technical projects of the IASB. The intention of making these changes was to raise the quality and consistency of financial reporting by drawing on best practice from around the world and eliminating a number of

optional accounting treatments. The IASB considered that these were topics that could all be dealt with relatively quickly and were not considered to be individually significant enough to warrant a separate project. The standards to be revised are:

- IAS 1 'Presentation of financial statements'
- IAS 2 'Inventories'
- IAS 8 'Net profit or loss for the period, fundamental errors and changes in accounting policies'
- IAS 10 'Events after the balance sheet date'
- IAS 16 'Property, plant and equipment'
- IAS 17 'Leases'
- IAS 21 'The effects of changes in foreign exchange rates'
- IAS 24 'Related party disclosures'
- IAS 27 'Consolidated financial statements and accounting for investments in subsidiaries'
- IAS 28 'Accounting for investments in associates'
- IAS 33 'Earnings per share'
- IAS 40 'Investment property'

Share-based payments

The use of shares or share options to reward employees or pay third parties is an increasingly common practice. There is, however, no existing international standard to cover how such awards should be accounted for.

The exposure draft, ED2 'Share-based Payments' was published on 7th November 2002 and an IFRS is due for issue in early 2004.

The exposure draft proposes that an entity should recognise all share-based payment transactions in its financial statements at fair value. For transactions with parties other than employees, there is a rebuttable presumption that the fair value of the goods or services received is more readily determinable. For transactions with employees (e.g. granting share options), the entity is required to measure the fair value of the equity instruments granted.

The exposure draft proposes that fair value should be based on market prices where available, or estimated by reference to some form of option pricing model.

There would be limited retrospective application to outstanding shares/options that were granted after the date on which the ED was published (7th November 2002).

Business combinations

The IASB's project on business

combinations is in two parts and Phase I has resulted in an exposure draft of a proposed IFRS to replace IAS 22 'Business Combinations' and proposed amendments to IAS 36 'Impairment of assets' and IAS 38 'Intangible assets'. The key changes proposed are:

- Removal of the pooling of interests method of accounting for business combinations.
- Restricting the recognition of restructuring provisions on acquisitions

to those which existed at the acquisition date.

- Goodwill would not be amortised, but it would be subject to annual impairment reviews.
- The concept of negative goodwill will be removed and the excess of the net fair value of assets and liabilities acquired over the fair value of consideration should be credited to income having firstly re-assessed the fair values of assets and liabilities.
- Prohibition of the reversal of impairment

losses for goodwill.

- Amendment to the definition of an intangible asset to one which is either separable or one which arises from contractual or other legal rights, regardless of whether those rights are transferable separately from the entity, and the cost can be measured reliably.
- Removable of the rebuttable presumption that intangible assets have a useful life of 20 years or less.

IASB timetable

The IASB's current timetable for of projects is set out below.

| | 2003 | | 2004 | |
|--|--------|------------|----------|--------------|
| | Qtr 3 | Qtr 4 | Qtr 1 | Later |
| Improvements to existing International Financial Reporting Standards | | IFRSs | | |
| Amendments to IAS 32 <i>Financial Instruments: Disclosure and Presentation</i> and IAS 39 <i>Financial Instruments: Recognition and Measurement</i> | | | | |
| <ul style="list-style-type: none"> • IAS 39 – limited amendment: <i>Fair value hedge accounting for a portfolio hedge of interest rate risk</i> | ED | | IFRS | |
| Financial risk and other amendments to financial instruments disclosures | | | | EDs |
| Business combinations, <i>Phase I</i> | | | IFRSs | |
| Share-based payment | | | IFRS | |
| Reporting comprehensive income | | ED | | IFRS |
| Business combinations <i>Application of the purchase method</i> | | ED | | IFRS |
| Insurance contracts <i>Phase I</i> | ED | | IFRS | |
| Insurance contracts <i>Phase II</i> | | | | ED |
| Concepts – revenues, liabilities and equity | | | | ED |
| Consolidation and special purpose entities | | | | ED |
| Short-term convergence of IFRS and other national accounting standards | | | | |
| <ul style="list-style-type: none"> • Joint project with FASB (phases I and II) | ED (I) | EDs (I&II) | IFRS (I) | IFRSs (I&II) |
| <ul style="list-style-type: none"> • Employee benefits | | ED | | IFRS |
| <ul style="list-style-type: none"> • Replacement of IAS 20 | | | | ED |

IFRS = International Financial Reporting Standard

ED = Exposure draft

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