

# RSM Reporting

**Welcome from  
the Editor**  
Marco Mongiello

Welcome to the sixth edition of RSM Reporting - the newsletter from RSM International covering technical developments in global accounting and reporting.

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With 2010 coming to an end, this edition already looks ahead to the next year and beyond, revolving around the concepts of fairness and accountability. Both well established fundamental concepts of accounting and reporting, fairness and accountability seem to show new aspects when considered together. It is from this interaction that much discussion will be pursued next year in the global accounting community.

Mike Brooks, this edition's guest contributor, sets the scene sharing with us his reflections on the role of reporting as a tool to support preparers' and auditors' accountability, demonstrating how far reaching their obligations towards the wider community of stakeholders may be, in terms of reporting disclosures and valuation choices.

Along these lines, it is somewhat intriguing that the IASB and FASB engage in a project to re-define 'one of the key financial measures for companies': revenue. Keith Parsons resumes the discussion we initiated in the first edition of this newsletter, exploring the challenges of defining a whole-encompassing concept of revenues that fulfils regulators' aims, preparers' expectations and users' needs globally.

As important as the above project is, with its ramifications in so many other aspects of accounting and reporting, Simon Fisher puts it in the wider context of IASB's agenda for 'June 2011 and beyond'. An agenda that seems to be torn between the goals of enhancing both simplification and fairness, where the first often entails more professional judgement, which, in turn, may affect the accounts' comparability and fairness.

The Top Ten Topics in IFRS, as always, complete the newsletter. This edition hosts Joelle Moughanni's second part of 'First-time adoption of IFRS', where she shares with us some of the key challenges encountered in applying IFRS 1. Joelle's implied note of optimism is given by her ability to dissect complex matters and provide us with simple explanations.

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## Accounting and Reporting this Quarter

### IASB/IASB

>> go to [www.ifrs.org](http://www.ifrs.org) to follow up any of the following news

### IASB/IASB

#### September 2010

The IASB published an Exposure Draft (ED) on deferred tax.

The proposed amendment of IAS 12 Income Taxes introduces a presumption that an asset is recovered entirely through sale unless the entity has clear evidence that recovery will occur in another manner.

With regards to the Emission Trading Scheme, the IASB and FASB discussed the initial accounting issues in a cap and trade scheme.

A tentative joint decision is that purchased and allocated allowances should be recognised as assets and that a liability exists when the allowances are allocated because the definition of a liability is met.

The boards still have to discuss the issues of measurement and presentation (including netting) and whether a right to future allocations can be recognised as an asset.

Regarding the fair value option for financial liabilities, the Board discussed "whether the effects of changes in a liability's credit risk should affect profit or loss and how to determine the effects of changes in a liability's credit risk".

In two separate deliberations, the Board made the following tentative decisions:

- For all liabilities designated under the fair value option, the effects of changes in a liability's credit risk will be required to be presented in other comprehensive income unless such treatment would create a mismatch in profit or loss. If such a mismatch would be created, the entire fair value change would

be required to be presented in profit or loss. An entity will be required to disclose the basis for its determination in the notes to the financial statements and to apply it consistently

- The guidance in IFRS 7 Financial Instruments: Disclosures will be used for the purposes of determining the amount of change in a liability's fair value that is attributable to changes in its credit risk, with some additional examples and guidance
- The effects of changes in a liability's credit risk will be presented in the statement of comprehensive income via a 'one-step approach'. Under that approach, the portion of the change in fair value attributable to changes in the liability's credit risk will be presented directly in other comprehensive income. All other changes in fair value will be presented in profit and loss
- Any finalised requirements on the treatment of credit risk will not apply to loan commitments and financial guarantee contracts designated under the fair value option. All fair value changes for those items will continue to be presented in profit and loss

The IASB and the FASB completed the first phase of their joint project to develop an improved conceptual framework for International Financial Reporting Standards (IFRSs) and US generally accepted accounting practices (GAAP).

#### October 2010

It was decided that Mr Hoogervorst will succeed Sir David Tweedie on his retirement as Chairman of the IASB at the end of June 2011. He is currently Chairman of the

Netherlands Authority for the Financial Markets (AFM), the Dutch securities and market regulator, Chairman of the Technical Committee of the International Organisation of Securities Commissions (IOSCO) and Co-Chair of the Financial Crisis Advisory Group (FCAG), an independent body of senior leaders formed to advise accounting standard-setters on their response to the global financial crisis.

Again on the Emission Trading Scheme, the IASB and FASB discussed the measurement of allowances (assets) and liabilities in a cap and trade scheme.

IASB presented four measurement models for measuring the allowances. The boards tentatively decided that the measurement of the allocated allowances and the liability for the allocation should be consistent and are inclined to refer to the model that measures the allocated allowances and liability for the allocation initially at fair value, and also subsequently measures those allocated allowances at fair value.

The boards also support an approach that determines the quantity of allowances to be returned based upon an entity's expectations of emissions, or emissions reductions.

Discussion is still pending on quantitative examples that illustrate measurement issues, when a liability is incurred for emissions in excess of the liability for the allocation, the issues of presentation (including netting) and whether a right to future allocations can be recognised as an asset.

## Accounting and Reporting this Quarter

### November 2010

The Trustees of the IFRS Foundation, the oversight body of the IASB, published a first-stage consultation document designed to solicit input on the strategy of the IFRS Foundation as it enters its second decade. The Trustees initiated this review as a result of the second Constitution Review that was completed earlier this year.

The Trustees are seeking views of stakeholders on four strategic fronts – the IFRS Foundation's mission, governance, the standard-setting process and financing of the IFRS Foundation. The Trustees invite public comment on the consultation document by 31 December 2010 and expect to conclude the strategy review during their meeting in March 2011.

### EFRAG

>> go to [www.efrag.org](http://www.efrag.org) to follow up any of the following news

### EFRAG

EFRAG has been broadly supportive of IASB's decisions, this quarter, and has devoted a lot of attention to its outreach programme with a number of standard-setters in Europe.

#### September 2010

The IASB ED on leasing proposes that a lessee should apply a right-of-use model in accounting for all leases. Depending on the extent to which a lessor retains exposure to risks and benefits associated with the underlying asset, a lessor should apply either a performance obligation approach or a derecognition approach.

EFRAG believes that the project is worth pursuing but the IASB needs to provide a robust and operational distinction between leases and service arrangements. If this is achieved the proposals would need significant changes to fulfil the objective of improving the accounting for leases.

#### November 2010

With regards to the IASB ED on Fair Value Measurement from May 2009, broadly supported by EFRAG, EFRAG again urged the IASB to reconsider the work it had done and the conclusions it has reached on the applicability of the guidance to non-financial items, and subject the results of that reconsideration, together with the accompanying reasoning, to public consultation and debate.

# 1 News and Updates

# News and Updates 1



## Marco Mongiello

### Presentation of items of other comprehensive income

#### Milestones

##### Objectives:

- > To establish a global standard that will guide the organisation and presentation of information in the financial statements.

##### Current status:

- > Comments letter (on exposure draft on amendments to IAS 1) period closed at the end of September.

##### What's next:

- > The Board plans to publish the amendments to IAS 1 by the end of December 2010.

(iii) Lack of comparability between IFRSs and US GAAP. US GAAP and IFRSs currently differ on the presentation of OCI items (*IFRS Foundation, ifrs.org*)

Displaying profit or loss and OCI consecutively, it is argued, is a possible solution, which will not affect the presentation of profit or loss (the net income line), how earnings per share are calculated and the attribution of profit or loss between the parent shareholders of the entity and its non-controlling interest.

However, the proposal is that items in the OCI should be grouped on the basis of whether they are reclassified from OCI to profit or loss. This should solve the problem of some of the items that are presented within OCI, e.g. cash flow hedges, being re-presented as part of the profit or loss section, whilst others, e.g. asset revaluations, are not.

A change in the name of the statement goes with the proposal, which suggests: 'Statement of Profit or Loss and Other Comprehensive Income', but no mention is made of a specific format for presentation.

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At the end of September, the comment period on the Exposure Draft on Presentation of Items of Other Comprehensive Income (OCI) was closed. The IASB is currently evaluating the comment letters. The project on Presentation of Items of OCI represents phase B of a broader project that we have previously addressed in this newsletter (Denise Gomez Soto, 4th Quarter 2009 - issue 2). This project is also important because it is part of the IASB/FASB Memorandum of Understanding.

The IASB and FASB have set out to solve the following problems:

- Lack of distinction between different items in OCI. A range of very different items are presented in OCI without any distinctions. However, some of the items presented in OCI can have a considerable effect on the overall financial performance of an entity
- Lack of consistency in presentation. Existing requirements give entities an option to present items of OCI. There are, however, substantially more options under US GAAP than IFRSs



## Tural Maharramov

### Proposed amendments to IFRS 5 Discontinued operations

#### Milestones

##### Objectives:

- > To establish a common definition of discontinued operations and requirement for common disclosures about components of an entity that have been (or will be) disposed of.

##### Current status:

- > 9 July 2010: The IASB posted a staff draft of the proposed standard.

##### What's next:

- > The Board plans to publish an Exposure Draft in Q1 2011 and the final IFRS in Q4 2011.

The project on discontinued operations is a joint project of the IASB and the FASB ('the Boards') to establish a common definition of discontinued operations and requirement for common disclosures about components of an entity that have been (or will be) disposed of. The Boards decided to address these issues separately from the financial statement presentation project.

The IASB published an Exposure Draft (ED) in September 2008 and invited comments until 23 January 2009. The main amendments to IFRS 5 in the ED in September 2008 were the following:

- that the definition of a discontinued operation should be based on operating segments, as defined in IFRS 8 Operating Segments
- proposed disclosures for all components of an entity that have been (or will be) disposed of
- not to include continuing involvement in the definition of a discontinued operation

After re-deliberating the issues raised in the comment letters, the Board has decided to re-expose its proposals in an ED. In July 2010, the IASB issued a staff draft of an exposure draft that reflects the Board's cumulative tentative decisions on discontinued operations, concluding with its joint FASB/IASB meeting in January 2010.

In summary the main proposals that would result from the Boards' tentative decisions are:

- retaining the definition in IFRS 5 and making only minor changes
- that for components of an entity that have been (or will be) disposed of, but do not meet the definition of a discontinued operation, specific disclosures would be required only for individually material components. Furthermore, the items to be disclosed for these components have been changed from the previous Exposure Draft so that disclosure would be less costly for preparers
- that, where applicable, disclosures regarding continuing involvement for all discontinued operations should be provided

In May 2010, the Boards decided to align the project timetable with the main financial statement presentation project. The Boards now plan to publish an ED in Q1 2011 of a converged definition of a discontinued operation, and related disclosures, and aim to issue improved and converged standards in Q4 2011.

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## 2 The point of view of ...



### Mike Brooks

.....on Governance and accountability: the fine line

I have, for rather more years than I care to remember, taken an active interest in various aspects of corporate governance. As an accountant by training who has pursued a career in financial management, much of this has inevitably focused on accounting matters. I suspect that, for a number of my contemporaries, a major advantage of choosing accountancy as a field of study was that it was (or appeared to be) a fixed subject - one that could be learned once and for all and that would thereafter support a solid and comfortable future career. Comfortable, that is, both materially and intellectually. Whatever, the material benefits such a career choice may have provided to my fellow students, it has not been the quiet and undemanding intellectual backwater that many of them may have believed they signed up to.

And it's all the fault of value. When financial reporting was firmly based on historical cost and it was widely regarded as professional suicide even to hint that there might be another, more suitable basis for the preparation of accounts, value was not an issue. While, no doubt, those entrants to the profession who had benefited from an academic training in economics may have harboured some doubts as to whether the issue of value would ever rear its ugly head in the world of financial accounting, the rest of the profession slumbered on in the confident belief that what had worked in the past would continue to do so for the foreseeable future.

The first major challenge to the status quo in the UK was the severe and prolonged period of inflation that began in the seventies and continued into the eighties. Both general and specific prices levels increased at such a frightening speed that most feared that financial accounting would collapse altogether. A hastily assembled set of proposals to deal with general inflation (current purchasing power accounting) and specific inflation (current cost accounting) were promulgated and immediately demonstrated many of the features of the current controversy around fair value accounting. Firstly, the technicalities of these methods were understood by relatively few professional accountants (and precious few shareholders) and, it was argued, that the very techniques of measuring profits under inflationary conditions were implicit in reinforcing this capital-destroying process. If not quite predicting the end of the world as we know it, opponents of inflation-adjusted accounting suggested that it would cause irretrievable damage to the capitalist economies.

Then inflation went away and we all forgot all about it. Phew!

In the meantime, the fair value argument has been gaining strength and largely underpinned the development of International Financial Reporting Standards for the last ten years or more. My concerns about this increased emphasis is not a technical one, although the technical challenge for preparers and auditors remains considerable, but is centred on the role of shareholders in understanding what these numbers mean and, perhaps more importantly, how this changed emphasis affects the behaviour of corporate management.

In a recent article in *Accountancy*, the journal of the Institute of Chartered Accountants in England and Wales, (*'More Than Their Fair Share' - June 2010*) I argued that there appeared to be an emerging consensus that shareholders have a responsibility, bordering on an obligation, to ensure proper governance in the companies in which they invest and to prevent the kind of excesses that are thought to have caused the financial crisis of recent years. I further argued that this is generally an obligation too far and that, while institutional investors, in particular, have a role to play, they are entitled to put their own interests first and, if that means selling the shares of companies whose practices they disapprove of, so be it. To argue that they ought to stay on the share register and put things right, is, in my view, not necessarily appropriate.

This is not to argue that shareholders have no role and many readers will no doubt be aware of the considerable efforts made by fund managers and other institutional shareholders to deal with areas of misgovernance. An example is provided by Newtons Fund Managers' quarterly publication *'Responsible Investment - Corporate Governance and SRI'* (available on their website) which details their voting behaviour as regards a number of issues. What is evident, from this and other similar reports, is that the issues usually relate to the independence of directors and their remuneration and only infrequently touch on accounting matters.

This is, perhaps, somewhat surprising in a predominantly fair value environment where the extent of board discretion regarding the balance sheet values of assets and liabilities has increased considerably. This is not to doubt for one moment the role of auditors in curbing excesses, nor to ignore the major role played by the financial analysts employed by fund managers. But I cannot help wondering whether the full extent of the reliance that is now placed on those who have responsibility for determining fair values, particularly where these are based on discounted cash flow models, is sufficiently realised by those who use financial statements.

When an organisation is preparing for the transition to IFRSs, it will usually be warned by its advisers that their adoption will often mean that profits and balance sheet ratios are likely to be more volatile than under previous GAAP. While it may be assumed that the users of financial statements are aware of this and are prepared to tolerate a higher degree of volatility than before, this may not actually be the case in practice. And, perhaps more importantly, the preparers of these financial statements may not be confident that this is the case and may wish to ensure that such volatility is minimised. Given that they probably have more scope to do this than would have existed under the traditional, historical cost approach, the question remains - what is the role of the shareholder in all of this?

To return to my main theme, I believe that, while an enhanced role is appropriate and that shareholders need to inform themselves more deeply than may have been the case previously, I do not see that they can be made to accept a wider responsibility to society for doing so. The governance model that currently exists, involving directors (particularly non-executive directors), auditors and shareholders should continue to be strengthened given the additional risks inherent in fair value accounting, and this might well involve much more disclosure than is currently required to substantiate the fair values put on particular classes of assets. Improved governance, of course, involves more than just an understanding of how the directors of a company have approached the issue of fair value and the extent to which they appear to be more conservative or more aggressive in their accounting policies than a risk-neutral shareholder might prefer. However, a clear understanding of this aspect of how they discharge their governance obligations in this area might provide an insight into the principles that guide the directors in fulfilling their wider responsibilities to all stakeholders.

But I would argue that, of these participants in the process, only the shareholders have the right to walk away. As a personal investor, I would expect those who manage my pension fund to put my interests first and, where I invest directly in a company, not to be burdened with the responsibility of looking out for my fellow shareholders and all those other stakeholders who have a legitimate interest in the wellbeing of the enterprise.

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#### Guest Contributor

**Mike Brooks**

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## 2 The point of view of ...



### Keith Parsons

#### ...on Fundamental changes proposed for revenue

Being the first line item on nearly all statements of profit and loss, revenue is one of the key financial measures for companies. Of all of the fraud schemes that have been perpetrated, revenue recognition fraud schemes are by far the most prevalent. No one can deny the importance of revenue to financial reporting. With the issuance of the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (FASB) joint exposure draft (ED) 2010/6 Revenue from Contracts with Customers, the Boards have taken the step toward the first, comprehensive principles-based revenue recognition standard. This ED will fundamentally change the way companies applying IFRSs across a whole host of industries will recognise revenue.

The Boards' objectives were to develop a single, common, comprehensive, principles-based revenue standard that can be applied consistently to complex transactions across any type of industry. Many of us are wondering what the impacts of this proposed standard might have on those applying IFRSs.

#### Single Revenue Standard for All Industries?

Like other standards under IFRSs, the ED includes exceptions to the scope of the standard including the following:

- Leasing contracts within the scope of IAS 17
- Insurance contracts within the scope of IFRS 4
- Contractual rights or obligations within the scope of IFRS 9
- Non-monetary exchanges between entities in the same line of business to facilitate sales to customers other than the parties to the exchange (e.g. exchange of oil to fulfil demand on a timely basis in a specified location or other exchanges of similar items)

However, it is possible that a contract might include items above that are outside the scope of the ED as well as other elements that are within the scope. In these situations, it would still be necessary to use the separation criteria found in the ED to account for each under the applicable guidance.

#### What are the basic concepts?

The ED requires a contract-based analysis that focuses on the assets and liabilities that are created when an entity enters into a contract. A contract is defined as "an agreement between two or more parties that creates enforceable rights and obligations". The basics of the ED can be boiled down to five "simple" steps:

- identify the contract(s) with a customer
- identify the separate 'performance obligations' in the contract
- determine the transaction price
- allocate the transaction price to the separate performance obligations
- recognise the allocated revenue when the entity satisfies each performance obligation

The specifics of these steps are covered below.

#### (1) Identify the contract with the customer

The ED introduces a somewhat new concept to IFRSs called "price interdependence". This concept requires an entity to (1) combine two or more contracts and account for them as a single contract, (2) segment a single contract and account for it as two or more contracts, or (3) account for a contract modification as a separate contract or as part of the original contract.

#### (2) Identify the separate 'performance obligations' in the contract

Under the ED, performance obligations are promises to provide goods or services to a customer through a mutually agreed upon contract. A company will account for a performance obligation separately only if the promised good or service is distinct, (i.e., if it is sold separately or has a distinct function and a distinct profit margin). Since IFRSs do not currently provide guidance for unbundling multiple element arrangements, companies may be using various methods to determine how to unbundle. As a result, this proposed step will have a significant impact on the timing of revenue recognition when multiple element arrangements exist.

#### (3) Determine the transaction price

Generally, the transaction price is readily determinable because the customer promises to pay a fixed amount of consideration and that payment is made at or near the time of the transfer of the promised goods or services. However, a company will need to adjust for items like the time value of money when a payment is due significantly before or after the transfer of goods or services. Also, variable transaction prices (discounts, rebates, bonuses, penalties, performance incentives etc.) will be recognised as the performance obligation being satisfied, if they can be reasonably estimated. Volatility may occur as estimates are updated. Finally, customer credit risk is factored in and impacts not if revenue is recognised (as under current IFRS) but how much revenue is recognised.

#### (4) Allocate the transaction price to the separate performance obligations

Under this step, a company will allocate the transaction price to all separate performance obligations in proportion to the relative stand-alone selling price of the good or service underlying each performance obligation. If the good or service is not sold separately, a company will need to estimate its stand-alone selling price. Subsequently, any change in the transaction price would be allocated to all performance obligations, including performance obligations that have been satisfied. If part of a change in the transaction price is allocated to a performance obligation that has been satisfied, then an adjustment to revenue would be recognised in the period in which the change occurs. However, the allocation would not be adjusted for changes in relative stand-alone selling prices.

#### (5) Recognise the allocated revenue when the entity satisfies each performance obligation

A company will recognise revenue when it satisfies a performance obligation by transferring the promised good or service to the customer. The good or service is transferred when the customer obtains control of the promised good or service. The amount of revenue recognised is the amount allocated to that performance obligation in Step 4.

#### Are there other issues?

The ED also addresses other areas not specifically discussed in this article including:

- Expanded disclosure requirements in the financial statements
- Costs of obtaining a contract
- Products sold with a right of return
- Warranties
- Licensing and rights to use
- Consideration payable to the customer
- Customer options for additional goods or services
- Customer acceptance
- Onerous performance obligations
- Bill and hold arrangements

#### Who will be impacted?

The ED will have an impact on most companies that currently apply IFRSs. The new concepts could cause significant changes in a number of industries, including information, communications and entertainment, construction, aerospace and defence, consumer markets and software and technology companies. Specifically, certain contracts where a percentage of completion method may apply, may be required to recognise revenue only when the final product is delivered to the customer. Companies that license intellectual property on an exclusive basis for less than its economic life may be required to recognise revenue over the term of the licence rather than at inception.

For further convergence between US GAAP and IFRSs to occur, a comprehensive model needs to be developed as the rules between US GAAP and IFRSs are significantly different. Although changes will most likely be made to the final standard, we expect the basic concept of a contract-based asset and liability model to survive.

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## 2 The point of view of ...



### Simon Fisher

...on IASB agenda: 'June 2011 and beyond'

The IASC Foundation (now the IFRS Foundation) held an IFRS Conference in London in June 2010. The conference was introduced by Sir David Tweedie, Chairman of the IAS Board (IASB) and the presenters included several members of the Board. This was therefore an excellent opportunity to hear about the future direction of financial reporting from those responsible for setting it.

The key theme of the conference was "June 2011 and beyond", focusing on the major projects currently being undertaken by the IASB to complete its convergence programme with both the US Financial Accounting Standards Board (FASB) and the Accounting Standards Board of Japan (ASBJ) by June 2011. Pursuant to their Memorandum of Understanding, IASB and FASB issued an updated work programme on 24 June 2010 for consideration by the G20 Leaders' Summit. At the conference Sir David identified the key priorities for the IASB over the next year as being to revise standards for:

- accounting for defined benefit plans
- financial statement presentation
- consolidation
- revenue recognition
- financial instruments
- insurance
- leases

The current status of each of these projects is summarised below.

#### Accounting for defined benefit plans

An Exposure Draft (ED), "Defined Benefit Plans", was published in April 2010. The draft proposes immediate recognition of all estimated changes in the cost of providing long term employee benefits and changes in the value of plan assets, with 'remeasurement' gains or losses being recognised in other comprehensive income. It also proposes changes to the disclosure requirements, with greater emphasis on the risks related to the obligation.



#### Financial statement presentation

This is in two phases. An ED "Presentation of Items of Other Comprehensive Income" was published in May 2010. This proposes a single "statement of profit or loss and other comprehensive income"

and separate presentation of items of other comprehensive income that will be subsequently reclassified to profit or loss from those items that will not.

The second phase is more ambitious, and will consolidate the existing IAS 7, Statement of Cash Flows, with IAS 1, Presentation of Financial Statements. IASB expects to publish an ED early in 2011 that will set out proposals for requiring the disaggregation of information so that it explains the components of an entity's financial position, financial performance and cash flows. Each of the primary statements would have a business section (including operating and investing categories), a financing section, an income tax section and a discontinued operation section, similar to the way in which the statement of cash flows is currently presented.



#### Consolidation

An ED for a replacement of IAS 27 has already been issued, and the revised standard is expected before the end of 2010. It proposes that the primary consideration for determining which entities to consolidate should be that of "the power to control". US GAAP will be converging towards this ED. There are issues concerning investment companies that will be dealt with in a further ED.



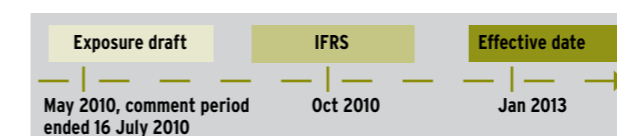
#### Revenue recognition

An ED has been published that would replace both IAS 18, Revenue, and IAS 11, Construction Contracts. This proposes a single, principles-based, model for recognising revenue requiring identification of the performance obligations in each contract with a customer, and recognising revenue once those obligations have been satisfied.



#### Financial instruments

The first instalment of IFRS 9, Financial Instruments, which will eventually replace IAS 39, has already been published (November 2009), as have EDs on the classification and measurement of financial liabilities and on impairment. The Board hope to be able to issue the complete IFRS 9 in the second quarter of 2011, and it will be effective for accounting periods beginning on or after 1 January 2013.



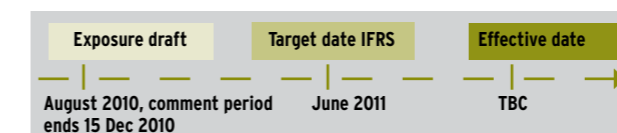
#### Insurance

This is a joint project with FASB, and an ED to replace IFRS 4, Insurance Contracts, was issued in July 2010 after a seven year gestation period. The ED aims to provide a unified basis for accounting for all insurance contracts, focusing on the drivers of insurance contract profitability and using current estimates of cash flows. It also proposes improvements to financial reporting that would provide more understandable and relevant information for users. The final standard is expected in the second quarter of 2011.



#### Leases

An ED to replace IAS 17, Leases, was published in August 2010. This represents a radical change and would require all leases to be recognised in the statements of financial position of lessees as both an asset (right of use) and a liability (present value of lease payments). Lessors would continue to take into account whether significant risks or benefits have been transferred. Again, the final standard is expected in the second quarter of 2011.



#### Other proposed changes

In addition to these key priorities, guidance on fair value measurement is well advanced and will be issued soon, as will amendments to the disclosure requirements in IFRS 7 relating to derecognition of financial instruments. Whilst the ED for a replacement of IAS 12, Income Taxes has been abandoned, the IASB is developing proposals for limited amendments dealing with the recovery of underlying assets. On the issue of 'liability v equity', IASB feels that the current guidance in IAS 32, Financial Instruments: Presentation, is appropriate, and it is hoped that FASB will converge towards this approach.

#### Conclusion

The above work plan represents a huge challenge not only for the IASB and its staff, but also for preparers and auditors of financial statements, who will want to study each of the proposed changes and give feedback to the IASB. The IASB has undertaken to limit the number of proposals issued in any one month, to allow commentators adequate time to consider them.

At the conference, Sir David Tweedie acknowledged that there were other standards that need to be revised, including IAS 28, Investments in Associates (Sir David's view was that this should be "abolished"), IAS 41, Agriculture, and IFRS 2 Share-based Payment, as well as a complete rethink of IAS 12, Income Taxes. But these projects will have to wait until after the IASB has delivered its commitments under the Memorandum of Understanding.

Whilst the thrust of many of the changes is simplification by moving from rules towards principles, Sir David himself expressed concern at the increasing number of items of income and expenses that will be recognised in 'Other comprehensive income', some of which will subsequently be recycled to profit or loss, while others will not. He expressed the view that 'Other comprehensive income' should be limited to long term gains and losses. Sir David also emphasised that, with the move towards principles-based standards, there will be an even greater need for the exercise of considered and sound professional judgement in the preparation of financial statements.

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# 3 Top Ten Topics in IFRS



**Joelle Moughanni**  
First-time adoption of IFRS

The previous issue of *RSM Reporting* provided a practical overview of the main requirements of IFRS 1 *First-time Adoption of International Financial Reporting Standards*. This article focuses on common key implementation issues mainly related to the exceptions and exemptions from IFRS 1's general principle of retrospective application of IFRSs.

## 1. In its opening IFRS statement of financial position, can a first-time adopter use the benefit of hindsight to adjust estimates based on information that was not available at the time the estimate was made under previous GAAP?

No. Accounting estimates required under IFRSs that were made under previous GAAP cannot be adjusted on transition, except to reflect differences in accounting policies or unless there is objective evidence that the estimates were in error. Instead, the entity reflects the new information in profit or loss (or, if appropriate, other comprehensive income) in the current period.

If an estimate was not required under previous GAAP, the entity should develop an estimate based on the information that would have been available at that time, however, reflecting conditions at the date of transition (in particular, market prices, interest rates and foreign exchange rates).

The same principle applies to comparative information presented in the first IFRS financial statements.

## 2. How could retrospective application of IFRSs be avoided for items of property, plant and equipment in the opening IFRS statement of financial position?

A first-time adopter can choose to apply one of the three following deemed costs<sup>1</sup>:

- Fair value at the date of transition to IFRSs
- Event-driven fair value at a date prior to transition to IFRSs (e.g. privatisation or IPO)
- Previous GAAP revaluation prior to transition to IFRSs, provided that revaluation was broadly comparable either to fair value or to adjusted cost under IFRSs (to reflect price index)

The entity chooses also the individual items of property, plant and equipment (even the individual components) to which it applies the deemed cost exemption, cherry-picking being allowed in this area.

In other terms, within a given category of PPE, the entity can choose to apply IAS 16 in the opening IFRS statement of financial position:

- Retrospectively to some items since their origin is based on their initial cost (without making use of the optional exemption of IFRS 1)
- Retrospectively to some items since a given event is based on their fair value at that date (event-driven fair value)
- Retrospectively to some items since their revaluation is based on their revalued amount at that date
- Prospectively to some other items from date of transition to IFRSs based on their fair value measured at that date

This deemed cost optional exemption applies also to investment properties under the cost model of IAS 40 and to intangible assets that meet both the recognition and revaluation criteria of IAS 38.

## 3. What if a subsidiary and its parent become first-time adopters at different dates?

If an entity becomes a first-time adopter later than its subsidiary, the entity does not have the choice in its consolidated financial statements but to measure the subsidiary's assets and liabilities at the same carrying amounts as in the IFRS financial statements of the subsidiary (except for adjustments for consolidation procedures).

However, this does not override the requirement to prepare the consolidated financial statements using consistent accounting policies. For example, if a parent adopts a policy of immediate recognition of all actuarial gains and losses without the use of the corridor (IAS 19), the amounts reported by a subsidiary using the corridor would be adjusted for the purposes of consolidation.

Also, these provisions do not override the business combination exemption. When used, the above applies only to assets and liabilities acquired after the business combination.

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

- the carrying amounts that are included in the parent's consolidated financial statements, based on the parent's date of transition to IFRSs (except for adjustments for consolidation procedures), or
- the carrying amounts required by IFRS 1 based on the subsidiary's date of transition to IFRSs.

The carrying amounts under these alternatives could differ when the exemptions in IFRS 1 result in measurement that depends on the date of transition to IFRSs (e.g. fair value as deemed cost for PPE). They could also differ when the accounting policies used in the subsidiary's financial statements differ from those in the parent's consolidated financial statements (e.g. corridor approach for pension plans).

These provisions apply equally to subsidiaries, associates and joint ventures.

The possible interaction between these provisions and other exceptions and exemptions of IFRS 1 (particularly the one relative to business combinations) prove to be sometimes complex and unclear in practice.

## 4. What is the optional exemption for business combinations about?

In a nutshell, when the business combination exemption is used:

- Classification of former business combinations (acquisition following legal form or uniting of interests) under previous GAAP is maintained
- Original 'fair values' determined at the time of the business combination are not re-measured (deemed cost)
- Carrying amount of goodwill recognised under previous GAAP is not adjusted (other than in specific instances mainly related to intangible assets)
- Any remaining goodwill in the opening IFRS statement of financial position is tested for impairment under IAS 36

In practice, this is one of the most complex areas first-time adopters need to address. Even where the exemption is applied, significant issues can arise.

Since deemed cost is the carrying value of assets and liabilities of the acquiree in the consolidated financial statements of the acquirer immediately after the acquisition, some adjustments need to be made to bring those deemed costs from the date of acquisition to the date

### Top Ten Topics

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2. Fair value measurement
3. Derecognition of financial instruments and Consolidation of Special Purpose Entities ✓
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6. Hedging
7. Deferred tax
8. Revenue recognition
9. Employee benefits
10. First-time adoption of IFRS ✓

of transition to IFRSs (simple example: depreciation).

However, if an asset acquired (or a liability assumed) in a past business combination was not recognised under previous GAAP immediately after the business combination, it does not have a deemed cost of zero in the opening IFRS statement of financial position. Instead, the acquirer shall recognise and measure it in its opening IFRS consolidated statement of financial position on the basis that IFRSs would require in the separate statement of financial position of the acquired entity. For instance, if the acquirer had not, under its previous GAAP, capitalised finance leases acquired in a past business combination, it shall capitalise those leases in its consolidated financial statements, as IAS 17 would require the acquiree to do so in its separate opening IFRS statement of financial position.

Despite the application of the business combination exemption, adjustments to goodwill may be required. In fact, goodwill is adjusted for the following:

- intangible assets that are recognised for the first time in accordance with IFRSs
- intangible assets that were recognised under previous GAAP, but that do not satisfy the IFRS recognition criteria
- adjustments to contingent consideration

<sup>1</sup> Deemed cost is an amount used as a surrogate for cost or depreciated cost at a given date. When used, deemed cost is the basis for subsequent depreciation and impairment.

# 3 Top Ten Topics in IFRS

Also, regardless of whether there is any indication that the goodwill may be impaired, the first-time adopter must systematically apply IAS 36 in testing the goodwill for impairment at the date of transition to IFRSs, based on conditions at that date.

The entity chooses to apply IFRS 3 prospectively either to business combinations taking place from the date of transition to IFRSs or starting at a prior date. However, if the entity chooses to restate a business combination that took place prior to the date of transition to IFRSs, it must then restate all later business combinations from that date, always using the same version of IFRS 3 effective at the reporting date.

The exemption for business combinations also applies to acquisitions of investments in associates and of interests in joint ventures, with the same selected date of prospective application of IFRS 3.

In conclusion, although IFRS 1 provides an exemption from the requirement to restate business combinations that occurred before the date of transition to IFRSs, this does not simply mean that all amounts recognised under previous GAAP relating to such business combinations can be carried forward under IFRSs. The detailed rules are quite complex.

## 5. What are the key differences between using the exemption and restating business combinations in accordance with IFRS 3?

As explained above, the decision to utilise the business combinations exemption on first-time adoption, and the point from which the exemption is applied, can have a substantial impact on an entity's first and subsequent IFRSs financial statements. These are summarised in the table below.

Issue	IFRS 1 exemption applied	IFRS 3 applied retrospectively
Classification	Keep classification as under previous GAAP.	Identify acquirer and acquiree under IFRS 3 (e.g. reverse acquisition).
Recognition	Recognise assets and liabilities identified at the date of transition to IFRSs in accordance with IFRSs (recognition criteria should be met). Exclude assets and liabilities not complying with IFRSs.	Recognise assets and liabilities identified at the date of acquisition in accordance with IFRS 3. Exclude assets and liabilities not complying with IFRSs.
Measurement	Measure cost-based assets and liabilities at the carrying amount under previous GAAP immediately after the business combination less subsequent accumulated depreciation under IFRSs. Measure other-measurement-based assets and liabilities on that basis at the date of transition (e.g. fair value). Measure assets and liabilities not recognised under previous GAAP as if the acquiree had adopted IFRSs retrospectively itself.	Measure all identifiable assets and liabilities in accordance with IFRS 3 (fair value at the date of acquisition). Adjust subsequently in accordance with relevant IFRS.
Goodwill	Keep carrying amount of goodwill at the date of transition. Adjust only for recognition / non-recognition of intangible assets at the date of transition and for impairment of goodwill. Goodwill previously deducted from equity remains in equity.	Determine and adjust goodwill at the date of acquisition in accordance with IFRS 3 (e.g. reversal of goodwill deducted from equity under previous GAAP). Reverse previous goodwill amortisation.

## 6. Should a first-time adopter consolidate a subsidiary that was not consolidated under previous GAAP?

Yes. In its opening IFRS statement of financial position, a first-time adopter must consolidate all entities that it has the power to control, even if they were not consolidated under previous GAAP.

The process to consolidate such a subsidiary in the opening IFRS statement of financial position can be summarised as follows:

- Identify the assets and liabilities of the subsidiary and adjust the carrying amounts to the amounts that IFRSs would require in the subsidiary's separate financial statements
- Calculate the deemed cost of goodwill as the difference at transition date between the parent's interest in the adjusted carrying amounts of the net assets of the subsidiary and the cost in the entity's separate financial statements of its investment in the subsidiary
  - "negative goodwill" is recognised directly in retained earnings
  - if the subsidiary was created by the parent (as opposed to acquired in a business combination), the difference is recognised in retained earnings (no goodwill)
- Test goodwill recognised for impairment at the date of transition.

## 7. Should a first-time adopter apply IAS 17 retrospectively to all its leases?

As there are no explicit exemptions or exceptions in IFRS 1 from retrospective application of IAS 17, an entity is required to recognise all assets held under finance leases at the date of transition to IFRSs. If such assets were not recognised under the previous GAAP, this involves:

- determining the fair value of the asset at inception of the lease (or the present value of the minimum lease payments, if lower) depreciated to the date of transition
- calculating the finance lease liability based on the net present value of the minimum lease payments amortised using the rate implicit in the lease.

It may be difficult and even impracticable to determine the fair value of the asset acquired in the lease; however, the entity may elect to measure the asset capitalised under a finance lease at fair value at the date of transition using the deemed cost optional exemption in IFRS 1 (see Q&A 2 above).

However, instead of determining retrospectively whether an arrangement contains a lease at the inception of the arrangement and subsequently reassessing that arrangement as required by IFRIC 4 in the periods prior to transition to IFRSs, the entity can choose to determine whether arrangements in existence on the date of transition to IFRSs contain leases, by applying IFRIC 4 to those arrangements on the basis of the facts and circumstances existing at the date of transition.

Also, if under its previous GAAP the entity has made an assessment as to whether an arrangement contains a lease at a date other than that required under IFRIC 4, it is not required to reassess its previous determination (only if that previous determination under its previous GAAP would have given the same outcome under IAS 17 and IFRIC 4).

## 8. Is there a specific treatment of cumulative translation differences upon first-time adoption of IFRSs?

Retrospective application of IAS 21 The Effects of Changes in Foreign Exchange Rates could be very onerous as it would require the entity to retrospectively determine the translation differences arising on the translation of the financial results of the foreign operation in accordance with IFRSs since the date on which the operation was formed or acquired.

Therefore, at the date of transition, an entity can choose to reset translation differences determined under previous GAAP to zero. The requirements of IAS 21 are then applied prospectively from the date of transition.

Finally, the gain or loss on subsequent disposal of a foreign operation will only include foreign exchange differences that arose after the date of transition.

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