

prescriptive, while the former relies more on judicial interpretation and precedent. Most of mainland Europe exemplifies the latter approach.

2. *Prescription or flexibility.* If regulation is not specified in full detail in legislation, then there are still two alternatives available. First, regulation might be created in detail by professional accounting bodies. Second, the broad regulation, whether created by legislation or by professional accounting bodies, may be explicitly designed on the assumption that the individual expert, in each unique situation, can and should choose the appropriate course of action within the broad parameters laid down. This was very much the approach in the Anglo-Saxon world before the creation of national standards bodies some 30 years ago.
3. *The role of the accounting profession.* In the Anglo-Saxon countries, the accounting profession plays an influential role in the private sector bodies that set financial accounting standards. In general, this is related to points (1) and (2) above, in that in Common Law jurisdictions there is generally a greater role for private sector bodies in setting accounting standards than in Code Law jurisdictions; an exception to this is The Netherlands, where there is a Roman (Code) Law tradition, but the accounting profession is influential.
4. *The providers of finance.* The national accounting systems developed before the 1970s predate the arguments of recent years that accounting statements must satisfy the needs of a wide variety of users. Generally, the suppliers of finance to business were the only users seriously considered until late in the last century (sometimes quite late). Different countries have very different financial institution structures and finance-raising traditions. It follows that accounting practice will have been adapted to suit the local dominant sources of finance. In some countries, tradition tends to focus on the shareholders and, therefore, on profit and on the reporting of expenses and revenues. Some other countries have more active banking sectors and fewer shareholder investors. Accounting in those countries will tend to focus on creditors, and therefore on the balance sheet and on the convention of prudence. Also, bankers tend to have access to "inside information" in those circumstances and are less reliant on annual reports.

A more obvious, but less often quoted, example of the influence of the finance provision on financial reporting can be seen by considering the systems of eastern Europe as they emerged from a half-century during which all finance was provided by the state.

5. *The influence of taxation.* The general point here is that the scope and extent of the influence of taxation law on financial statements vary considerably. Perceptions of this are often simplistic. In reality, no country can justly claim that tax considerations do not influence published results, and no country can be accused of simply taking tax-based results and publishing them just as they are. Within these nonexistent extremes, however, lies a variety of tradition and practice. It is common in many countries, for instance, for some tax allowances to be claimable only if

the identical figure from the tax computation is also used in the published financial statements.

The most powerful of these causal factors creating and explaining historical differences is almost certainly the sources of finance. It is arguably this same factor that is now driving the move toward internationalism in financial reporting and its regulation. The market for the *supply* of finance for larger enterprises is now a single global market. If our analysis is correct, this means that the *demand* for finance is inevitably forced to operate in a single global market scenario. The demand for globally understood financial reports is therefore logically unstoppable.

As we have already hinted, the above arguments, which in our view are fully justified at the "listed enterprise" level, do not necessarily imply any need to alter national financial reporting as it applies to small businesses. They certainly do not logically apply to the economies of many third-world countries. The implications for possible "two-tier" systems within countries and between economic regions raise significant issues, which both IASB and national regulatory systems have hardly begun to tackle, though discussion of such problems is outside the scope of this book. Historically, IASB GAAP have sought applicability, in general, to all enterprises, in all types of economy. However, the IASB has come under increasing pressure to devote serious effort to assisting the financial reporting needs of both smaller countries and smaller enterprises. On February 15, 2007, the IASB published an exposure draft on its "International Financial Reporting Standard for Small and Medium-sized Entities." The aim of the proposed standard is to provide a simplified, self-contained set of accounting principles that are appropriate for smaller, non-listed companies and are based on full IFRSs, developed primarily for listed companies. Simplifications were proposed in three ways: (1) by removing choices for accounting treatment where they exist in the full IFRS, (2) by eliminating topics that are not generally relevant to small and medium-sized entities (SMEs), and (3) by simplifying methods for recognition and measurement. The IASB has now issued the Standard. Its use, as far as IASB is concerned, is never compulsory, but national governments could make it so within their own jurisdiction. Section P8 clarifies "general purpose financial statements are those directed through general financial information needs of a wide range of users who are not in a position to demand reports tailored to meet their particular information needs". P11 states "SMEs often produce financial statements only for the use of owner-managers or only for the use of tax authorities or other governmental authorities. Financial statements produced solely for those purposes are not necessarily general purpose financial statements". This last point seems to raise doubts about the logical applicability of this Standard.

Given the position and role of the IASB, and the widely differing practices and attitudes of its constituents, is it really valid to talk of generally accepted accounting principles in the IASB context? Is IASB GAAP the same species of animal as, say, U.S. GAAP, distinguished only by relatively minor genetic individualities? Or is it of a different species? How fundamental is the difference

3. to assist national standard-setting bodies in developing national standards;
4. to assist preparers of financial statements in applying IASs and in dealing with topics that have yet to form the subject of an IAS;
5. to assist auditors in forming an opinion as to whether financial statements conform with IASs;
6. to assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with IASs;
7. to provide those who are interested in the work of the IASC with information about its approach to the formulation of accounting standards.

Scope

The scope of the Framework was indicated in the Overview given above. Paragraph 5 of the Framework mentions the following as constituting its scope:

1. Objectives of financial statements.
2. Qualitative characteristics that determine the usefulness of financial statement information.
3. Definition, recognition, and measurement of financial statement elements.
4. Concepts of capital and capital maintenance.

The Framework is concerned with "general purpose financial statements," including consolidated financial statements. These are described as being prepared and presented at least annually and being directed toward the common information needs of a wide range of users. They do not include special purpose reports such as prospectuses and tax computations (par. 6).

The term *financial statements* is understood as comprising a balance sheet, an income statement, a statement of changes in financial position (see the Observation below), and those notes and other statements and explanatory material that are an integral part of the financial statements. Supplementary schedules and information derived from, and expected to be read with, financial statements may also be included. Examples are segment reporting and information about the effects of changing prices. However, financial statements do not include such items as directors' reports, chairman's statements, management reports, and similar material that may be included in a financial or annual report (par. 7).

The Framework applies to the financial statements of all commercial, industrial, and business reporting entities, whether in the private or the public sectors (par. 8).

OBSERVATION: The wording of paragraph 7 reads oddly in parts. The reference to the statement of changes in financial position states that this "may be presented in a variety of ways, for example as a statement of cash flows or a statement of funds flows." However, IAS 7 (revised in 1992) clearly requires a statement of cash flows (see Chapter 8). Likewise, it is stated that financial

statements "may . . . include supplementary . . . information [such as] . . . financial information about industrial and geographical segments." Yet IAS 14, originally issued in 1981, *requires* such information (see Chapter 31). Hence, these apparent discrepancies are only partly the result of the Framework not having been revised. It seems that paragraph 7 does not set out fully to reflect the implications of IASs as to what should be considered as making up "financial statements."

USERS AND THEIR INFORMATION NEEDS, THE OBJECTIVE OF FINANCIAL STATEMENTS, AND UNDERLYING ASSUMPTIONS

Users and Their Information Needs

The Framework (par. 9) cites seven categories of "users" of financial statements, with comments on their needs. The seven categories are investors, employees, lenders, suppliers and other trade creditors, customers, governments and their agencies, and the public. The Framework argues that there are needs for financial statement information that are common to all users, and that, because investors are providers of risk capital to the entity, financial statements that meet their needs will also meet "most of the needs of other users that financial statements can satisfy" (par. 10).

OBSERVATION: This argument to the effect that, as investors provide risk capital, basing financial statements on their needs will satisfy (as far as is practicable) most of the needs of other users, is not obviously correct and begs some questions that are not addressed in the Framework. The FASB employed similar but not identical wording in SFAC 1, referring to "investors and creditors" rather than just "investors." The FASB stated in support of its position that the information needs (or, at least, the decision models) of investors and creditors are reasonably well known, and better known than those of such other groups as customers and employees.

Objective of Financial Statements

The Framework states that the objective of financial statements is to provide information about the *financial position, performance, and changes in financial position* of an enterprise that is useful to a wide range of users in making economic decisions. It is acknowledged that financial statements do not provide all the information that users may need to make economic decisions, since they are largely oriented toward the *financial effects of past events* (pars. 12—13). Paragraph 14 mentions the use of financial statements for assessing the stewardship or accountability of management but sees such assessments as included within economic decisions.

Paragraphs 15—18 provide conventional explanations of the ways in which information about financial position, performance, and changes in financial position is useful. Information about financial position is primarily provided in a

Plant, and Equipment" (see Chapter 27), but disclosure of current assets has no additional standard, except for component parts such as Inventories, covered by IAS 2, "Inventories" (see Chapter 23).

Broadly speaking, IAS 1 consists of two parts. Part 1 discusses a number of "overall considerations," consisting of general principles, conventions, and requirements. Much of Part 1 is a restatement of aspects of the Framework, discussed in Chapter 2. It should be remembered that the Framework does not have the status of a standard, whereas IAS 1 obviously does. Part 2 discusses in some detail the required contents of general purpose financial statements. It is worth noting that most national accounting standards operate, and are designed to operate, within the context of national legislation, especially for corporations. There is, of course, no single international company or corporation statute. To some extent, IAS 1 provides a minimal filling in of this lacuna.

BACKGROUND

To understand how and why IAS 1 as currently constituted came about, it is helpful to look at the chronology involved. The very first standard issued by the IASC was the original IAS 1, "Disclosure of Accounting Policies," effective for accounting periods beginning on or after January 1, 1975. IAS 5, "Information to Be Disclosed in Financial Statements," related to periods beginning on or after January 1, 1977, and IAS 13, "Presentation of Current Assets and Current Liabilities," related to periods beginning on or after January 1, 1981. All three of these were fairly short standards, with limited objectives accurately indicated by their titles.

Later, as its approach became generally more sophisticated, the IASC developed its "Framework for the Preparation and Presentation of Financial Statements." As discussed in detail in Chapter 2, this sets out the concepts that underlie the preparation and presentation of financial statements designed for external users. This document appeared in its agreed-upon form in 1989. It was intended to inform the preparation of standards and so improve consistency over time, but it is of a lower status than the standards, which override the Framework if any conflict occurs.

IAS 1, as revised in 1997, was the next step in this long process of development. It replaced the original IAS 1 and both IAS 5 and IAS 13, but it did a great deal more than merely update the three original standards. In particular, it dealt not only with the disclosure of accounting policies, as did the original IAS 1, but also with the whole issue of policies and conventions, incorporating significant parts of the 1989 Framework (thereby increasing the status of those aspects so incorporated to full standard requirement).

It attempted to provide something approaching a philosophy of financial reporting, together with an overview of the complete required contents of published financial reports. Its gestation was at times fraught with disagreement.

IAS 1 was further revised in 2004, as part of the IASB improvements project. The revised version was formally required for annual periods beginning on or after January 1, 2005, with earlier adoption encouraged. The fundamental ap-

proach and structure of the standard was not altered, but a number of changes were made. The requirements relating to the selection and application of accounting policies were transferred to IAS 8 (see Chapter 5), and the presentation requirements relating to the income statement for the period were transferred from IAS 8. The concept of extraordinary items was eliminated and the phrase was deleted from the IASB Glossary.

The concept of materiality was formally introduced into both IAS 1 and IAS 8. This replaced an earlier statement in the former Preface to IASs; the current Preface to IFRSs makes no mention of materiality. IAS 1 now specifies the application of materiality to disclosures (and IAS 8 now specifies its application to applying accounting policies and to correcting errors and to changes in estimates). Various disclosure requirements were clarified or tightened. In particular, new guidance on the meaning and significance (or lack of significance, see below) of "present fairly" was added. A further small amendment was made in August 2005 and is discussed toward the end of the chapter, in a section titled "Notes to the Financial Statements."

Finally, several significant further amendments were made in a revised version of IAS 1 that was issued in September 2007 (see the Financial Statements section below). These amendments also affect a number of other IASs/IFRSs, mainly with regard to terminology. Compliance with the 2007 version of IAS 1 is required for annual reporting periods beginning on or after January 1, 2009, although earlier adoption is permitted.

This latest version (from January 1, 2009), makes a number of significant amendments summarized below:

- A complete set of financial statements
 - The terms "statement of financial position" and "statement of cash flows" are used in place of "balance sheet" and "cash flow statement."
 - A new requirement is introduced to include in a "complete set of financial statements" a statement of financial position as at the beginning of the earliest comparative period whenever an entity either (i) retrospectively applies an accounting policy or (ii) makes a retrospective restatement or reclassification of items in its financial statements.
- Reporting owner changes in equity and comprehensive income
 - All changes in equity arising from transactions with owners in their capacity as owners (owner changes in equity) are to be presented separately from non-owner changes in equity. Thus, components of comprehensive income (i.e., non-owner changes) must not be presented in the statement of changes in equity.
 - Income and expense are to be presented either in one statement (a statement of comprehensive income) or in two statements (a separate income statement and a statement of comprehensive income), separately from owner changes in equity.
 - Components of "other comprehensive income" are to be displayed in the statement of comprehensive income.

XYZ Group—Disclosure of Tax Effects Relating to Each Component of Other Comprehensive Income—Notes for the Year Ended December 31, 20X7

20X7

(in thousands of currency units)

	Before-Tax Amount	Tax (Expense) Benefit	Net-of-Tax Amount
Exchange differences on translating foreign operations	5,334	(1,334)	4,000
Available-for-sale financial assets	(24,000)	6,000	(18,000)
Cash flow hedges	(667)	167	(500)
Gains on property revaluation	933	(333)	600
Actuarial gains (losses) on defined benefit pension plans	(667)	167	(500)
Share of other comprehensive income of associates	400	—	400
Other comprehensive income	(18,667)	4,667	(14,000)

CASH FLOW STATEMENTS

IAS 1 says nothing about cash flow statements, merely referring to IAS 7, "Statement of Cash Flows." The reader is, in turn, referred to our full discussion in Chapter 8.

NOTES TO THE FINANCIAL STATEMENTS

In one sense, the notes to the financial statements are "where everything else goes." IAS 1 summarizes the functions of the notes as being to (par. 112):

1. Present information about the basis of preparation of the financial statements and the specific accounting policies used.
2. Disclose the information required by International Standards that is not presented elsewhere in the financial statements.
3. Provide additional information that is not presented on the face of the financial statements but that is relevant to an understanding of them.

Notes to the financial statements should be presented in a systematic manner. Each item on the face of the balance sheet, statement of comprehensive income, separate income statement (if presented), and cash flow statement should be cross-referenced to any related information in the notes.

The standard suggests that notes "are normally" presented in the following order:

1. A statement of compliance with IFRSs.
2. A summary of significant accounting policies applied.
3. Supporting information for items presented in the key statements in the order in which each statement and each line item is presented.

4. Other disclosures, including:

- (a) Contingent liabilities (see IAS 37, Chapter 28) and unrecognized contractual commitments.
- (b) Non-financial disclosures, such as the entity's financial risk management objectives and policies (see IFRS 7, Chapter 16).

IAS 1 goes to considerable length in discussing disclosure requirements in the notes. However, the central requirements are reasonably clear and reasonably succinct—an entity must disclose the following:

- *In the summary of significant accounting policies*—the measurement basis or bases used in preparing the financial statements and the other accounting policies used that are relevant to an understanding of the financial statements.
- *In the summary of significant accounting policies or other notes*—the judgments, apart from those involving estimations (see below), management has made in the process of applying the entity's accounting policies that have the most significant effect on the amounts recognized in the financial statements.
- *In the notes*—information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the balance sheet date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next financial year. In respect of those assets and liabilities, the notes shall include details of their nature and their carrying amount as at the balance sheet date.
- *In the notes*—the amount of dividends proposed or declared before the financial statements were authorized for issue but not recognized as a distribution to equity holders during the period, and the related amount per share; and the amount of any cumulative preference dividends not recognized.
- *In the notes*—details relating to puttable financial instruments classified as equity instruments (par. 136A, inserted in February 2008).
- *In information published with the financial statements (if not disclosed elsewhere)*:
 - The domicile and legal form of the entity, its country of incorporation, and the address of its registered office (or principal place of business, if different from the registered office).
 - A description of the nature of the entity's operations and its principal activities.
 - The name of the parent and the ultimate parent of the group.
 - If it is a limited life entity, information regarding the length of its life.

An entity shall disclose information that enables users of its financial statements to evaluate the entity's objectives, policies, and processes for managing capital. Therefore, the entity must disclose the following (pars. 134–36):

opening balance of each affected component of equity for the earliest prior period presented and the other comparative amounts disclosed for each prior period presented as if the new accounting policy had always been applied. However, when it is impracticable, as defined and discussed earlier, to determine the period-specific effects of changing an accounting policy on comparative information for one or more prior periods presented, the entity must apply the new accounting policy to the carrying amounts of assets and liabilities as at the beginning of the earliest period for which retrospective application is practicable (which may be the current period), and make a corresponding adjustment to the opening balance of each affected component of equity for that period.

It may, of course, be impracticable to determine the cumulative effect of applying the new policy, even as at the beginning of the current period. In this, relatively rare, situation, the entity applies the new policy *prospectively* from the start of the earliest period practicable. It therefore disregards the portion of the cumulative adjustment to assets, liabilities, and equity arising before that date. Changing an accounting policy is permitted even if it is impracticable to apply the policy prospectively for any prior period. Paragraphs 50–53 provide guidance on when it is impracticable to apply a new accounting policy to one or more prior periods. Hindsight, in the sense of becoming aware of circumstances that could not have been foreseen at the time of the original preparation of financial statements for prior periods, should not be used to change presented amounts.

Disclosure

The disclosure requirements relating to changes in accounting policies are, unfortunately, both lengthy and precise. When initial application of a standard or an interpretation has an effect on the current period or any prior period, would have such an effect except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

- The title of the IFRS.
- When applicable, that the change in accounting policy is made in accordance with its transitional provisions.
- The nature of the change in accounting policy.
- When applicable, a description of the transitional provisions.
- When applicable, the transitional provisions that might have an effect on future periods.
- For the current period and each prior period presented, to the extent practicable (a) the amount of the adjustment for each financial statement line item affected and (b) if IAS 33, "Earnings per Share," applies to the entity, for basic and diluted earnings per share.
- The amount of the adjustment relating to periods before those presented, to the extent practicable.
- If retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures.

When a *voluntary* change in accounting policy has an effect on the current period or any prior period, would have an effect on that period except that it is impracticable to determine the amount of the adjustment, or might have an effect on future periods, an entity shall disclose:

- The nature of the change in accounting policy.
- The reasons why applying the new accounting policy provides reliable and more relevant information.
- For the current period and each prior period presented, to the extent practicable (a) the amount of the adjustment for each financial statement line item affected and (b) if IAS 33 applies to the entity, for basic and diluted earnings per share.
- The amount of the adjustment relating to periods before those presented, to the extent practicable.
- If retrospective application is impracticable for a particular prior period, or for periods before those presented, the circumstances that led to the existence of that condition and a description of how and from when the change in accounting policy has been applied.

Financial statements of subsequent periods need not repeat these disclosures.

When an entity has not applied a new standard or interpretation that has been issued but is not yet effective, the entity must disclose this fact and known or reasonably estimable information relevant to assessing the possible impact that application of the new standard or interpretation will have on the entity's financial statements in the period of initial application.

CHANGES IN ACCOUNTING ESTIMATES

As already discussed, changes in accounting estimates are inherent in the day-to-day subjectivity of the business world and must be distinguished from both errors and changes in accounting policy. A change in the measurement basis applied is a change in an accounting policy, and is not a change in an accounting estimate. When it is difficult to distinguish a change in an accounting policy from a change in an accounting estimate, the change is treated as a change in an accounting estimate.

The effect of a change in an accounting estimate should be recognized prospectively by including it in profit or loss in (1) the period of the change, if the change affects that period only or (2) the period of the change and future periods, if the change affects both.

To the extent that a change in an accounting estimate gives rise to changes in assets and liabilities or relates to an item of equity, it should be recognized by adjusting the carrying amount of the related asset, liability, or equity item in the period of the change.

Prospective recognition of the effect of a change in an accounting estimate means that the change is applied to transactions, other events, and conditions

Measurement Period

The initial accounting for a business combination may be incomplete at the end of the reporting period in which the combination occurs, because either the fair values to be assigned to the acquiree's identifiable assets, liabilities, and contingent liabilities or the cost of the combination can be determined only provisionally at that time. In that case, the acquirer should account for the combination using the provisional amounts (IFRS 3, pars. 45–50).

The *measurement period* is the period after the acquisition date during which the acquirer is required to adjust these provisional amounts retrospectively to reflect new information obtained about facts that existed as of the acquisition date which, if known at that time, would have affected the measurements of these items. The acquirer is also required to recognize additional assets or liabilities if, in light of new information obtained about facts that existed at the acquisition date, would have been recognized as of that date.

Subject to not exceeding one year from the acquisition date, the measurement period ends as soon as the acquirer has received the information being sought about facts that existed as of the acquisition date or learned that no more information is available. This provides the acquirer with a reasonable time to obtain the information necessary to identify and measure the following as of the acquisition date in accordance with the requirements of IFRS 3:

- The identifiable assets acquired, liabilities assumed, and any non-controlling interest in the acquirer.
- The consideration transferred for the acquiree (or the other amount used in measuring goodwill if no consideration is transferred (see "Recognizing and Measuring Goodwill" above).
- In a business combination achieved in stages, the equity interest in the acquiree previously held by the acquirer.
- The resulting goodwill or gain on a bargain purchase.

During the measurement period, the acquirer recognizes adjustments to the provisional amounts as if the accounting for the business combination had been completed at the acquisition date. Comparative information presented for prior periods is to be revised as needed, including any change in depreciation, amortization, or other items affecting income that are recognized in completing the initial accounting for the business combination.

Any adjustments made after the measurement period should be recognized only to correct an error in accordance with IAS 8, "Accounting Policies, Changes in Accounting Estimates, and Errors" (see Chapter 5). In the absence of a change in accounting policy, IAS 8 requires an entity to adjust its financial statements retrospectively only to correct an error.

Subsequent Measurement and Accounting

Other IFRSs provide guidance on subsequently measuring and accounting for assets acquired and liabilities assumed or incurred in a business combination (IAS 3, par. B63):

- IAS 38 prescribes accounting for identifiable intangible assets acquired in a business combination. The acquirer measures goodwill at the amount recognized at the acquisition date less any accumulated impairment losses. IAS 36 prescribes accounting for impairment losses.
- IFRS 4 provides guidance on the subsequent accounting for an insurance contract acquired in a business combination.
- IAS 12 prescribes the subsequent accounting for deferred tax assets acquired (including those unrecognized in a business combination) and liabilities assumed in a business combination.
- IFRS 2 provides guidance on subsequent measurement and accounting for the portion of replacement share-based payment awards issued by an acquirer that is attributable to employees' future services.
- IAS 27 (as amended in 2008) provides guidance on accounting for changes in a parent's ownership interest in a subsidiary after control is obtained.

IFRS 3, paragraphs 54–58, states some exceptions to the general rule that an acquirer subsequently measures and accounts for assets acquired, liabilities assumed, and equity instruments issued in a business combination in accordance with other applicable IFRSs. These exceptions concern:

- Reacquired rights;
- Contingent liabilities recognized at the acquisition date;
- Indemnification assets; and
- Contingent consideration.

Reacquired Rights

A reacquired right recognized as an intangible asset is amortized over the remaining contractual period of the contract in which the right was granted. If it is subsequently sold to a third party, the acquirer includes the carrying amount of the intangible asset in determining the gain or loss on the sale.

Contingent Liabilities

After initial recognition of a contingent liability recognized in a business combination, and until it is settled, cancelled, or it expires, the acquirer measures it at the higher of:

- The amount that would be recognized in accordance with IAS 37.
- The amount initially recognized less, if appropriate, cumulative amortization recognized in accordance with IAS 18, "Revenue" (see Chapter 30).

This requirement does not apply to contracts accounted for in accordance with IAS 39.

Indemnification Assets

At the end of each subsequent reporting period, the acquirer measures an indemnification asset that was recognized at the acquisition date on the same basis as the indemnified liability or asset, subject to any contractual limitations on the amount of the indemnity and, for an indemnification asset that is not

It should be noted, however, that IAS 11 applies only to contracts “specifically negotiated.” This seems to imply that only customized production is included. Also noteworthy is that the given definition implies no particular length of the construction period. We are talking about contracts, not long-term contracts. In practice, however, if no accounting period-ends are crossed, then no problems of revenue and expense recognition exist, so nothing remains to be resolved.

Sometimes one contract covers the construction of a number of assets. If three conditions are met, then each asset is required to be treated as a separate construction contract. These conditions are (par. 8):

1. Separate proposals have been submitted for each asset.
2. Each asset has been subject to separate negotiation, and the contractor and customer have been able to accept or reject that part of the contract relating to each asset.
3. The costs and revenues of each asset can be identified.

Conversely, a group of contracts, whether with one or with several different customers, may be in substance a single construction contract, and required to be treated as a single contract when, again, three conditions are met. These are (par. 9):

1. The group of contracts is negotiated as a single package.
2. The contracts are so closely interrelated that they are, in effect, part of a single project with an overall profit margin.
3. The contracts are performed concurrently or in a continuous sequence.

A typical example of this last case would be contracts for the design, and then building, of a particular project. Contracts may allow “add-on” options subject to further agreement. Such an add-on should be treated as part of the original contract unless either the asset differs significantly in design, technology, or function from the asset or assets covered by the original contract or the price of the asset is negotiated without regard to the original contract price.

SERVICE CONCESSION ARRANGEMENTS

Service concession arrangements are arrangements in which a government or some other public body grants contracts for the supply of public services, such as roads, energy distribution, prisons, or hospitals, to private operators. IFRIC 12, “Service Concession Arrangements,” (issued in November 2006 and mandatory for accounting periods beginning on or after January 1, 2008, with early application permitted) addresses the accounting implications of such arrangements. An arrangement within the scope of this Interpretation typically involves a private sector entity (an operator) constructing the infrastructure used to provide the public service or upgrading it (e.g., by its capacity) and operating and maintaining that infrastructure for a specified period of time. The operator is paid for its services over the period of the arrangement. The arrangement is governed by a contract that sets out performance standards, mechanisms for adjusting prices, and arrangements for arbitrating disputes. Such an arrangement is often described as a “public-to-private” service concession arrangement.

The service arrangement contractually obliges the operator to provide the services to the public on behalf of the public sector entity. Other common features are:

- The party that grants the service arrangement (the grantor) is a public sector entity, including a governmental body, or a private sector entity to which the responsibility for the service has been devolved.
- The operator is responsible for at least some of the management of the infrastructure and related services and does not merely act as an agent on behalf of the grantor.
- The contract sets the initial prices to be levied by the operator and regulates price revisions over the period of the service arrangement.
- The operator is obliged to hand over the infrastructure to the grantor in a specified condition at the end of the period of the arrangement, for little or no incremental consideration, irrespective of which party initially financed it.

IFRIC 12 applies to public-to-private service concession arrangements if:

1. The grantor controls or regulates what services the operator must provide with the infrastructure, to whom it must provide them, and at what price.
2. The grantor controls—through ownership, beneficial entitlement, or otherwise—any significant residual interest in the infrastructure at the end of the term of the arrangement.

It applies to both:

1. Infrastructure that the operator constructs or acquires from a third party for the purpose of the service arrangement.
2. Existing infrastructure to which the grantor gives the operator access for the purpose of the service arrangement.

The Interpretation sets out general principles on recognizing and measuring the obligations and related rights in service concession arrangements. Requirements for disclosing information about service concession arrangements under SIC-29 are discussed in Chapter 3. The issues addressed in IFRIC 12 are outlined below.

- *Treatment of the operator’s rights over the infrastructure.* Infrastructure within the scope of this Interpretation shall not be recognized as property, plant, and equipment of the operator because the contractual service arrangement does not convey the right to control the use of the public service infrastructure to the operator.
- *Recognition and measurement of arrangement consideration.* The operator recognizes and measures revenue in accordance with IAS 11 and IAS 18 for the services it performs. If the operator performs more than one service (e.g., construction or upgrade services and operation services) under a single contract or arrangement, consideration received or receivable shall be allocated by reference to the relative fair values of the services delivered, when the amounts are separately identifiable.

then this would be so fundamental that the basis of the preparation of the accounts *would* be changed, to reflect the likelihood of imminent liquidation.

IAS 10 was originally issued in 1978 under the title "Contingencies and Events Occurring after the Balance Sheet Date." Much of the content of this standard was replaced by IAS 37, "Provisions, Contingent Liabilities, and Contingent Assets," which was effective for accounting periods beginning on or after July 1, 1999 (fully discussed in Chapter 27). The remainder, very confusingly in terms of the numbering system, was replaced by a new IAS 10 (revised 1999), called "Events after the Balance Sheet Date," effective for accounting periods beginning on or after January 1, 2000. With one exception, the new IAS 10 did not involve major changes from the post-balance-sheet event parts of the old IAS 10. Minor amendments to IAS 10 were made by the revisions to IAS 1, issued in 2007. These included an unhelpful change in the title from "Events after the Balance Sheet Date," to "Events after the Reporting Period."

BACKGROUND

As outlined above in the "Overview," IAS 10 seeks to ensure logical consistency in the extent to which events occurring in an enterprise between the date of the annual financial statements and the date of the finalization of those statements are, or are not, taken into account in the published annual financial statements. The standard should be applied in accounting for, and to the disclosure of, all events occurring after the reporting balance sheet date. IAS 10 is on the whole simple, clear, and succinct.

There are no differences of principle between IASB GAAP and U.S. GAAP. However, IAS 10 now requires that dividends, proposed or declared after the balance sheet date, are not adjusting events. Under U.S. GAAP the declaration of a cash dividend is non-adjusting, but the declaration of a stock dividend is adjusting. A further revision was issued for IAS 10 (revised 2004), effective from January 1, 2005, with earlier application encouraged. The only further change of substance was actually minor, relating to the declaration of dividends, and is discussed below.

DEFINITIONS

The definitions of the two types of post-balance sheet events can be simply stated (par. 3).

Events after the reporting period are those events, both favorable and unfavorable, that occur between the end of the reporting period and the date when the financial statements are authorized for issue. Two types of events can be identified:

1. Those that provide evidence of conditions that existed at the balance sheet date (*adjusting events after the reporting period*); and
2. Those that are indicative of conditions that arose after the balance sheet date (*non-adjusting events after the reporting period*).

Events after the balance sheet date include all events up to the date when the financial statements are authorized for issue, even if those events occur after the publication of a profit announcement or of other selected financial information.

Care may need to be taken in determining the date of "authorization" for this purpose. Inevitably, the standard has to allow for a variety of different national systems of corporate governance and of management structure. As a general rule, the date of authorization is the date on which the executive directors approve the financial statements. If the financial statements are, for example, required to be submitted to the shareholders for approval after issue or required to be approved by a non-executive supervisory board after acceptance by the executive management of the enterprise, then these later dates are not relevant for IAS 10 purposes. IAS 10 gives two simple examples illustrating these points (pars. 5–6).

The standard gives some indicative illustrations of adjusting and non-adjusting events, which require logical application of the above definitions (pars. 9 and 11). For example, the resolution after the balance sheet date of a court case that, if it confirms that an entity already had a present obligation at the balance sheet date, may require the entity to adjust a provision already recognized or to recognize a provision instead of merely disclosing a contingent liability. This would, therefore, be an adjusting event. Similarly, information about the realizability of accounts receivable in existence at the balance sheet date, or about the net realizable value of items held in inventory at the balance sheet date, would be regarded as adjusting events. The discovery of errors, or the results of fraud, that show that the draft financial statements were incorrect is also specifically stated to be an adjusting event.

On the other hand, an example of a non-adjusting event after the balance sheet date is a decline in market value of investments between the balance sheet date and the date when the financial statements are authorized for issue. The fall in market value would not normally relate to the condition of the investments at the balance sheet date but would reflect circumstances that had arisen in the following period. Therefore, an entity would not adjust the amounts recognized in its financial statements for the investment, except in the rare situation of the going concern assumption being put at risk (see "Going Concern," below).

RECOGNITION AND MEASUREMENT

Now obvious, the formal requirements can be very briefly stated (pars. 8 and 10). An entity should adjust the amounts recognized in its financial statements to reflect adjusting events after the reporting period. It should not adjust the amounts recognized in its financial statements to reflect non-adjusting events after the reporting period.

The one major change introduced by the 1999 revision to IAS 10, further amended by the 2004 revision, concerns the treatment of dividends. IAS 10 now states that if dividends to holders of equity instruments (as defined in IAS 32, "Financial Instruments: Disclosure and Presentation," see Chapter 16) are declared after the balance sheet date, then an entity should not recognize those dividends as liabilities at the balance sheet date (par. 12). This reflects the normal

Designation of Financial Items as Hedged Items

A hedged item that is a financial asset or financial liability may be a hedged item with respect to the risks associated with only a portion of its cash flows or fair value, provided the effectiveness of a partial hedge can be measured.

In a fair value hedge of the interest rate exposure of a portfolio of financial assets or liabilities (and only in such a hedge), the hedged portion may be designated in terms of an amount of money (i.e., a currency) rather than as individual asset or liability items. However, designation of a *net amount* of assets less liabilities (or vice versa) is not permitted. The entity may hedge only a portion of the interest rate risk of this designated amount, such as, for example, in the case of a portfolio containing prepayable assets, the change in fair value attributable to changes in the hedged interest rate on expected, rather than contractual, repricing dates. However, hedge effectiveness may be affected if such a portfolio is hedged with a non-prepayable derivative and the prepayment dates are revised or are different from those expected.

Designation of Non-Financial Items as Hedged Items

In contrast, a hedged non-financial asset or non-financial liability should be designated as a hedged item either (a) for foreign currency risks or (b) in its entirety for all risks. This is because changes in the price of a component of a non-financial asset generally do not have a predictable and separately measurable effect on the price of the item itself, unlike (for example) the effect of a change in market interest rates on the price of a bond.

Designation of Groups of Items as Hedged Items

If similar assets or liabilities are aggregated and hedged as a group, the individual assets or liabilities in the group will share in the designated risk exposure. Any change in fair value of an individual item in the group that is attributable to the hedged risk will be expected to be approximately proportional to the overall change in fair value of the group attributable to the hedged risk of the group.

→ **PRACTICE POINTER:** If an entity acquires a portfolio of shares to replicate a stock index and also a put option on the index to hedge against fair value losses on the portfolio, the put may not be designated as a hedging instrument in a hedge of the portfolio. This is because the changes in the individual fair values of the shares in the portfolio cannot be expected to be approximately proportional to the overall change in fair value of the portfolio.

A firm commitment to acquire a business in a business combination cannot be a hedged item (except with respect to exchange risk, if applicable), since no other risks can be specifically identified and measured.

Hedge Accounting

By virtue of hedge accounting, there is symmetrical recognition of the offsetting effects on net profit or loss of changes in the fair values of the hedging

instrument and the related hedged item within a hedging relationship. Hedging relationships are of three types:

1. A *fair value hedge* is a hedge of the exposure to changes in the fair value of a recognized asset or liability, or of an identified portion of such an asset or liability, that is attributable to a particular risk and will affect reported net income.
2. A *cash flow hedge* is a hedge of the exposure to variability in cash flows that (a) is attributable to a particular risk associated with (i) a recognized asset or liability, such as interest payments on variable rate debt, or (ii) a forecasted transaction, such as an anticipated purchase or sale; and (b) could affect profit or loss.
3. A *hedge of a net investment in a foreign operation* is as defined in IAS 21, "The Effects of Changes in Foreign Exchange Rates" (see Chapter 17). Under IAS 21, all foreign exchange differences that result from translating the financial statements of a foreign entity are recognized directly in equity until disposal of the net investment.

A hedge of the foreign currency risk of a firm commitment may be accounted for either as a fair value hedge or as a cash flow hedge.

A hedging relationship qualifies for hedge accounting only if all of the following conditions are met (IAS 39, par. 88):

1. The hedging relationship and the entity's risk management objective and strategy in undertaking the hedge should be formally documented from the inception of the hedge, which must be formally designated, providing identification of the hedging instrument and the related hedged item or transaction, the nature of the hedged risk, and the manner in which the effectiveness of the hedging instrument's effectiveness will be assessed.
2. The hedge is expected to be "highly effective" (see "Assessing Hedge Effectiveness") in a manner consistent with the risk management strategy documented as required in item 1, above.
3. For cash flow hedges, the forecast transaction that is hedged must be *highly probable* and must present exposure to variations in cash flows that could ultimately affect profit or loss.
4. The effectiveness of the hedge can be reliably measured, that is, the fair value or cash flows of the hedged item that are attributable to the hedged risk and the fair value of the hedging instrument can be reliably measured.
5. The hedge is assessed on an ongoing basis and determined actually to have been highly effective throughout the financial reporting periods for which it was designated.

Assessing Hedge Effectiveness

A hedge is considered as "highly effective" only if both of the following conditions are satisfied:

- The loss of control of a subsidiary that includes a foreign operation.
- The loss of significant influence over an associate that includes a foreign operation.
- The loss of joint control over a jointly controlled entity that includes a foreign operation.

With the exception of the above, any reduction in an entity's ownership interest in a foreign operation is a *partial* disposal.

On disposal of a subsidiary that includes a foreign operation, the cumulative amount of the exchange differences relating to the foreign operation that have been attributed to the non-controlling interests are derecognized but not reclassified to profit or loss. On the *partial* disposal of a subsidiary that includes a foreign operation, the entity reattributes the proportionate share of the cumulative amount of the exchange differences recognized in other comprehensive income to the non-controlling interests in that operation. In any other *partial* disposal of a foreign operation, the entity reclassifies to profit or loss only the proportionate share of the cumulative amount of the exchange differences recognized in other comprehensive income.

An entity may dispose or partially dispose of its interest in a foreign operation through sale, liquidation, repayment of share capital, or abandonment of all or part of that entity. A write-down in the carrying amount of a foreign operation either because of its own losses or because of an impairment recognized by the investor is not a partial disposal and does not result in any cumulative exchange differences, previously recognized directly in other comprehensive income, being reclassified to profit or loss of the period (IAS 21, paras. 48–49).

TAX EFFECTS OF EXCHANGE DIFFERENCES

Gains and losses on foreign currency transactions, and exchange differences arising on the translation of financial statements of foreign operations, may have tax effects, which should be dealt with according to IAS 12, "Income Taxes" (see Chapter 20).

OBSERVATION: In fact, IASB GAAP have little to say about this matter, which is addressed briefly in IAS 12, paragraphs 41 and 62–63. One problem for an international standard on such a topic is the different tax treatment of such items in different jurisdictions.

DISCLOSURE

An entity (which may be an enterprise or a group) should disclose:

- The amount of exchange differences recognized in profit or loss except for those arising on financial instruments measured at fair value through profit or loss in accordance with IAS 39.

- Net exchange differences classified in a separate component of equity and a reconciliation of the amount of such exchange differences at the beginning and end of the period.

When the presentation currency is different from the functional currency, that fact should be stated, together with disclosure of the functional currency and the reason for using a different presentation currency.

When there is a change in the functional currency of either the reporting entity or a significant foreign operation, that fact and the reason for the change in functional currency shall be disclosed. When an entity presents its financial statements in a currency that is different from its functional currency, it describes the financial statements as complying with International Financial Reporting Standards only if the statements comply with all the requirements of each applicable standard and each applicable interpretation of those standards, including the translation method set out in IAS 21.

When an entity displays its financial statements or other financial information in a currency that is different from either its functional currency or its presentation currency and the requirements of the preceding paragraph are not met in full, it must:

1. Clearly identify the information as supplementary information to distinguish it from the information that complies with International Financial Reporting Standards;
2. Disclose the currency in which the supplementary information is displayed; and
3. Disclose the entity's functional currency and the method of translation used to determine the supplementary information.

OBSERVATION: This last point is intended to deal with various so-called convenience translations. IASB does not wish to outlaw such practices, but it is determined that readers of financial statements be absolutely clear in their own minds that any such statements are additional to, and in no sense part of, fair presentation under IASB GAAP.

TRANSITIONAL PROVISIONS

In general, IAS 8, "Accounting Policies, Changes in Accounting Estimates, and Errors," applies when the revised IAS 21 is first used. A complicated requirement relates to the goodwill requirement in par. 47, as discussed above. This is as follows (par. 59):

An entity shall apply paragraph 47 prospectively to all acquisitions occurring after the beginning of the financial reporting period in which IAS 21 is first applied. Retrospective application of paragraph 47 to earlier acquisitions is permitted. For an acquisition of a foreign operation treated prospectively but which occurred before the date on which the standard is first applied, the entity does not restate prior years and accordingly may, when appropriate, treat goodwill and fair value adjustments arising on that acquisition as assets and liabilities of the entity rather than as assets and liabilities of the foreign

1. There is a current tax liability of \$30.
2. There is an eventual further tax liability of \$3 ($33 - 30$), which becomes current in years 4 or 5. Under the accruals principle (see Chapter 2), it is clear that this \$3 arises as a result of the activities and earnings of year 1 and is therefore a liability at the end of year 1 (see the definition of liability in Chapter 2). Because it is not a current liability (the current taxation creditor being \$30), it must be a deferred liability, which is settled by the end of year five. The amount to be transferred to the credit of the deferred tax account can be formally calculated as follows.

Amount equals:

$$\text{Tax rate} \times (\text{taxation allowances given} - \text{depreciation disallowed})$$

Thus for year 1:

$$33\% \times (25 - 15) = 3$$

and year 2:

$$33\% \times (18 - 15) = 1$$

	Year					Total
	1	2	3	4	5	
Profit before tax	\$100	\$100	\$100	\$100	\$100	\$500
Taxation: payable for year	30	32	33	34	36	165
Additional charge (credit) to deferred tax account	3	1	0	(1)	(3)	0
Total tax charge	33	33	33	33	33	165
Profit after tax	\$67	\$67	\$67	\$67	\$67	\$335

In this simple situation, it seems to make no difference whether we make the argument in terms of the income statement (equalizing the tax charge) or in terms of the balance sheet (recording all liabilities—or possibly assets) according to the general definitions of IASB GAAP. In the general case, as discussed later, it can make a difference. The original version of IAS 12 focused essentially on the income statement; the revised version now in force focuses on the balance sheet.

One practical consideration much argued by businesses in some jurisdictions is that, given (a) a stable tax regime, (b) a tendency for rising price levels, and (c) a tendency toward capital intensive expansion, it follows that the deferred tax account is likely to grow and grow, as the reversal of earlier temporary differences is more than counterbalanced by the originating temporary differences on new non-current assets. Formally, three approaches can be distinguished to this consideration:

1. *The flow-through approach*, which accounts only for that tax payable in respect of the period in question, that is, temporary differences are ignored.
2. *Full deferral*, which accounts for the full tax effects of differences, that is, tax is shown in the published accounts based on the full accounting

profit, and the element not immediately payable is recorded as a liability until reversal.

3. *Partial deferral*, which accounts only for those differences where reversal is likely to occur in aggregate terms (because, for example, replacement of assets and expansion is expected to exceed depreciation).

Approach 1, which ignores deferred tax considerations altogether, is the old system before the 1970s. Approach 2 is that required by IAS 12 and in the United States. Approach 3, for many years, was required in the United Kingdom, but full deferral is now required there, from 2002.

Another issue of principle arises because it is quite likely that, over the years during which a tax liability is deferred, tax rates are likely to change. Two approaches can be distinguished, known as the deferral method and the liability method. Under the *deferral method* of provision for deferred tax, the tax effects of temporary differences are calculated by using the tax rates current when the differences arise. No adjustments are made subsequently if tax rates change. Reversals are accounted for by using the tax rates in force when the temporary differences originated, although in practice the effects of reversal and new temporary differences are sometimes accounted for as one item.

Those who support this method recognize that, when tax rates change, this method will not give an indication of the amount of tax payable or recoverable. Any deferred tax balance will, therefore, be a deferred charge or credit rather than a liability or asset. When tax rates change, there is no need to revise the deferred tax already provided. Thus the tax charge or credit for the period relates solely to that period and is not distorted by any adjustments relating to prior periods.

Alternatively, it could be argued that the balances on the deferred tax account should be regarded as liabilities payable in the future or as assets receivable in the future. The best available estimate of the tax rate ruling in the future when the amount is to be paid or received will generally be the current tax rate. This means that the liability balance will need to be continually revised whenever the current tax rate changes. This is known as the *liability method*. Thus, the tax charge or credit for the period may include adjustments of accounting estimates relating to prior periods. The deferred tax provision represents the best estimate of the amount that would be payable or receivable if the relevant differences reversed.

The original IAS 12 had, in broad terms, an income statement focus, although with considerable optionality. It permitted either full or partial deferral using either the deferral method or a version of the liability method that focused on temporary differences between various income statement years. The revised IAS 12 requires full deferral, using a different variant of the liability method, which it terms the balance sheet liability method, described in detail below, which takes account of all temporary differences. The distinction is again one of income statement versus balance sheet.

approach, views an interim period as a component, or integral, part of the annual reporting period. Within this second approach, the purpose of interim financial reporting is to provide information over the course of the annual period that helps to anticipate annual results.

To some extent, IASB GAAP follow the second integral philosophy. They do not require that seasonal or cyclical revenues or expenses are smoothed out, as they can be properly interpreted as indicators of annual performance, given proper comparison figures plus further explanation if necessary. IAS 34 seeks to ensure that such meaningful comparison and necessary explanation are provided. There are no major differences between IASB and U.S. GAAP as promulgated in APB-28. It should be remembered as a general point, however, that many stock exchanges have their own rules in relation to enterprises quoted thereon.

SCOPE AND DEFINITIONS

As already indicated, IASB GAAP do not of themselves require the preparation and publication of interim financial reports by any entity, listed or otherwise. The fact that an entity may not have provided interim financial reports during a particular financial year or may have provided interim financial reports that do not comply with IAS 34 does not prevent the entity's annual financial statements from conforming to international standards if they otherwise do so. However, if an entity's interim financial report is described as complying with international standards, it must comply with all of the requirements of IAS 34. Thus, IAS 34 applies to all entities that are required, or elect, to publish an interim financial report in accordance with international standards. IASB "encourages" publicly traded (listed) entities (par. 1) to provide interim financial reports at least as of the end of the first half of their financial year and to make their interim financial reports available not later than 60 days after the end of the interim period.

The standard gives two formal definitions, as follows (par. 4):

- *Interim period* is a financial reporting period shorter than a full financial year.
- *Interim financial report* means a financial report containing either a complete set of financial statements (as described in IAS 1, "Presentation of Financial Statements," see Chapter 3) or a set of condensed financial statements (as described in this standard) for an interim period.

IAS 34 makes it clear that it does not intend in any way to "discourage" the issue of an interim complete set of financial statements, that is, in full accord with IAS 1 (which requirement automatically embraces all other applicable IASs). The IAS itself, however, specifies the minimum components of an interim financial report as follows (par. 8):

1. A condensed statement of financial position;
2. A condensed statement of comprehensive income, presented as either:
 - (a) A condensed single statement, or
 - (b) A condensed separate income statement and a condensed statement of comprehensive income;

3. A condensed statement of changes in equity;
4. A condensed statement of cash flows; and
5. Selected explanatory notes.

It is to be assumed that a reader of an interim financial report also has access to the previous full annual financial statements. The interim report, therefore, focuses on new circumstances and need not duplicate information previously reported.

FORM AND CONTENT OF INTERIM FINANCIAL STATEMENTS

As already discussed, an entity may, if it chooses, issue its interim financial statements in full accord with IAS 1. Otherwise, if an entity publishes a set of condensed financial statements in its interim financial report, those condensed statements should include, at a minimum, each of the headings and subtotals that were included in its most recent annual financial statements and the selected explanatory notes as required by IAS 34. Additional line items or notes should be included if their omission would make the condensed interim financial statements misleading. Basic and diluted earnings per share should be presented on the face of each income statement, complete or condensed, for each interim period.

The interim report should be as consistent as possible, for example, regarding consolidation, with the most recent annual financial statements. The condensed changes in equity statement (see component 3, above) should also be consistent with that of the annual statements.

This relatively brief comment deals with components 1—4 of the condensed interim report. The element of subjectivity involved in the question of "additional line items or notes" should be observed. However, IAS 34 deals with the content of required explanatory notes (note that component 5 does not include the word "condensed") in detail. Again, it is assumed that the previous full financial statements are available to the reader, so the notes in the interim reports should focus on an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the enterprise since the last annual reporting date.

An entity should include the following information, as a minimum, in the notes to its interim financial statements, if material and if not disclosed elsewhere in the interim financial report (par. 16). The information should normally be reported on a financial year-to-date basis. However, the entity should also disclose any events or transactions that are material to an understanding of the current interim period:

1. A statement that the same accounting policies and methods of computation are followed in the interim financial statements as with the most recent annual financial statements or, if those policies or methods have been changed, a description of the nature and effect of the change;
2. Explanatory comments about the seasonality or cyclicity of interim operations;

ACCOUNTING AND REPORTING BY LESSEES—FINANCE LEASES

In the case of finance leases, the substance and financial reality are that the lessee acquires the economic benefits of the use of the leased asset for the major part of its economic life in return for entering into an obligation to pay for that right an amount approximating to the fair value of the asset and the related finance charge.

Lessees should recognize finance leases as assets and liabilities in their balance sheets at amounts equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments (par. 20). In calculating the present value of the minimum lease payments, the discount factor is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate should be used. At the inception of the lease, the asset and the liability for the future lease payments are recognized in the balance sheet at the same amounts.

During the lease term, each lease payment should be allocated between a reduction of the obligation and the finance charge to produce a constant periodic rate of interest on the remaining balance of the obligation over the amortization period. The asset initially recorded is depreciated in a manner consistent with that used by the lessee for owned assets.

If the circumstances described in situations 1 or 2 above are present, that is, a transfer of ownership is clearly foreseeable, then depreciation is usually based on the economic life of the leased asset; otherwise, it is based on the shorter of economic life and lease term. Contingent rentals are generally not included in the minimum lease payments and are not accounted for as part of the capitalized lease. They should be charged to expense in the period to which they relate.

Illustration of Finance Lease Accounting by the Lessee

A lessee leases an asset on a non-cancelable lease contract with a primary term of 5 years from January 1, 20X1. The rental is \$650 per quarter payable in advance. The lessee has the right to continue to lease the asset after the end of the primary term for as long as it wishes at a nominal rent. In addition, the lessee is required to pay all maintenance and insurance costs as they arise. The leased asset could have been purchased for cash at the start of the lease for \$10,000 and has a useful life of 8 years.

The interest rate implicit in the lease can be found as follows:

From the definition of "interest rate implicit in the lease," we can state that:

1. \$10,000 (fair value) = the present value at implicit interest rate of 20 quarterly rentals payable in advance of \$650.
2. The present value of the first rental payable is \$650 as it is paid now.
3. Thus, \$9,350 = the present value at implicit interest rate of 19 rentals of \$650.
4. Therefore, $9,350/650 = 14.385$ = annuity present value factor at implicit interest rate of 19 rentals of \$1.

5. Using discount tables and interpolating, we can determine the quarterly interest rate to be 2.95%.

Assuming the asset has a nil residual value and that the asset is to be leased for a further 2 years after the primary period, we can show the accounting entries over the life of the lease required in the lessee's books.

The lease falls within the definition of a finance lease; therefore, the "rights in the lease" will be capitalized at fair value of \$10,000 and the obligation under the lease of \$10,000 will be shown as a liability, as shown by the following journal.

1/1/X1	Fixed asset	10,000	
	Creditors (lessor)		10,000

The minimum lease payments amount to $20 \times \$650 = \$13,000$; the cash price was \$10,000; hence, the total finance charge will be \$3,000.

Remembering that this total finance charge should be allocated to accounting periods during the lease to produce a constant periodic rate of charge on the remaining balance of the obligation for each accounting period, then an appropriate method of allocation would be the actuarial method as follows:

Period	Capital Sum at Start of Period	Rental Paid	Capital Sum during Period	Finance Charge (2.95% per Quarter)*	Capital Sum at End of Period
	\$	\$	\$	\$	\$
1/X1	10,000	650	9,350	276	9,626
2/X1	9,626	650	8,976	265	9,241
3/X1	9,241	650	8,591	254	8,845
4/X1	8,845	650	8,195	242	8,437
				1,037	
1/X2	8,437	650	7,787	230	8,017
2/X2	8,017	650	7,367	217	7,584
3/X2	7,584	650	6,934	205	7,139
4/X2	7,139	650	6,489	191	6,680
				843	
1/X3	6,680	650	6,030	178	6,208
2/X3	6,208	650	5,558	164	5,722
3/X3	5,722	650	5,072	150	5,222
4/X3	5,222	650	4,572	135	4,707
				627	
1/X4	4,707	650	4,057	120	4,177
2/X4	4,177	650	3,527	104	3,631
3/X4	3,631	650	2,981	88	3,069
4/X4	3,069	650	2,419	71	2,490
				383	
1/X5	2,490	650	1,840	54	1,894

adjustments to the amount of the distribution. When an entity settles the dividend payable, it shall recognize the difference, if any, between the carrying amount of the assets distributed and the carrying amount of the dividend payable in profit or loss.

OBSERVATION: In its basis for conclusions supporting IFRS 5, the IASB devotes a number of paragraphs to the measurement question. Most of this discussion is concerned with the rationale for not depreciating—essentially that, by definition, the resources are no longer being held for use. Why the “fair value less costs to sell” criterion is used is not really explained, except that it gives consistency with IAS 36, “Impairment of Assets” (see Chapter 19). The fact that it is not consistent with IAS 39, “Financial Instruments: Recognition and Measurement” (see Chapter 16), or IAS 40, “Investment Property” (see Chapter 24), both of which focus on fair value *without* deduction of costs to sell, is not mentioned.

PRESENTATION AND DISCLOSURE

Once again, we are given a statement of principle, printed in bold type in the original IFRS itself (par. 30), requiring an entity to present and disclose information that enables users of the financial statements to evaluate the financial effects of discontinued operations and disposals of non-current assets (or disposal groups). What follows, then, is a considerable degree of detail, as expected (and note that, explicitly, “all paragraphs have equal authority”—that is, bold type is not more important in the IFRS than a normal font).

Regarding the presentation and disclosure of non-current assets or disposal groups classified as held for sale, the significant requirements are as follows (pars. 38 — 42). An entity should present a non-current asset classified as held for sale and the assets of a disposal group classified as held for sale separately from other assets in the balance sheet. The liabilities of a disposal group classified as held for sale should be presented separately from other liabilities in the balance sheet. Those assets and liabilities are not to be offset and presented as a single amount. The major classes of assets and liabilities classified as held for sale are to be separately disclosed either on the face of the balance sheet or in the notes. An entity must present separately any cumulative income or expense (i.e., gains or losses) recognized directly in equity relating to a non-current asset (or disposal group) classified as held for sale. Such gains or losses would relate either to re-measurements, at fair value, or to currency translation difference on net investment under IAS 21, “The Effects of Changes in Foreign Exchange Rates.” If, however, the disposal group is a newly acquired subsidiary that meets the criteria to be classified as held for sale on acquisition, disclosure of the major classes of assets and liabilities is not required. (Note that comparative figures are not restated, thus throwing the classification as held for sale into stark relief.)

An entity shall disclose the following information in the notes in the period in which a non-current asset (or disposal group) has been either classified as held for sale or sold:

1. A description of the non-current asset (or disposal group);
2. A description of the facts and circumstances of the sale, or leading to the expected disposal, and the expected manner and timing of that disposal;
3. The gain or loss recognized and, if not separately presented in the statement of comprehensive income, the caption in that statement that includes that gain or loss; and
4. If applicable, the segment in which the non-current asset (or disposal group) is presented in accordance with IFRS 8, “Operating Segments” (see Chapter 31).

The effects of changes in plans for sale must be explained and quantified.

OBSERVATION: There is a curious, and important, omission from the disclosure requirements of held-for-sale items. A non-current asset classified as held for sale is to be presented separately from other assets—but is it still a non-current asset? The rules of language and grammar indicate that it is: a non-current asset held for sale is logically a subclass of non-current assets. On the other hand, the item is likely, though not guaranteed, to meet criterion 3 of the definition of current asset given earlier in this chapter—that is, to be expected to be realized within 12 months. And, categorically, it is intended for sale, not for continuing use.

The definition and the disclosure sections of IFRS 5 are completely silent on this question. Nevertheless, it is clear that without bothering to specify so properly the IASB considers held-for-sale items as current. Recall the statement from the scope section of the IFRS (par. 3):

Assets classified as non-current in accordance with IAS 1, “Presentation of Financial Statements” shall not be reclassified as current assets until they meet the criteria to be classified as held for sale in accordance with this IFRS. Assets of a class that an entity would normally regard as non-current and that are acquired exclusively with a view to resale shall not be classified as current unless they meet the criteria to be classified as held for sale in accordance with this IFRS.

This wording indicates an expectation of eventual reclassification as current assets. Further, the example of presentation given in the IFRS 5, “Implementation Guidance,” indicates by its use of position and subtotals that a designation as current assets is assumed. Note, however, that the contents of an “Implementation Guidance” are *not* “requirements.” The Guidance “accompanies, but is not part of, IFRS 5.” IFRS 5 does not appear to *require* non-current resources held for sale to be presented as associated with current assets, but we have no doubt that their intention was to require precisely this.

PRESENTATION AND DISCLOSURE OF DISCONTINUED OPERATIONS

So far, we have not spent much time in this chapter on discontinued operations, though we considered the relevant definitions of a discontinued operation and component of an entity, and we discussed the rationale for distinguishing the results of discontinued and continuing operations in the context of user needs. The main reason for this omission is that there are no measurement issues

that, ultimately, the amount recognized for goods or services received as consideration for the equity instruments granted is based on the number of equity instruments that eventually vest. Hence, on a cumulative basis, no amount is recognized for goods or services received if the equity instruments granted do not vest because of failure to satisfy a vesting condition (e.g., the counterparty fails to complete a specified service period) or a performance condition is not satisfied, subject to the requirements of paragraph 21.

To apply the requirements of paragraph 19, the entity recognizes an amount for the goods or services received during the vesting period based on the best available estimate of the number of equity instruments expected to vest and should revise that estimate, if necessary, when subsequent information indicates that the number of equity instruments expected to vest differs from previous estimates. On the vesting date, the entity revises the estimate to equal the number of equity instruments that ultimately vested, subject to the requirements of paragraph 21.

The Implementation Guidance issued by IASB contains a number of worked illustrations of these requirements. They are not only instructive of the meaning and interpretation of the requirements in the standard itself, they also throw into high relief some of the implications of these detailed requirements. Reproduced, slightly adapted, are two of these examples (numbers 3 and 5), with the implications highlighted.

Illustration of a Grant with a Performance Condition in Which the Number of Equity Instruments Varies

At the beginning of year 1, entity A grants share options to each of its 100 employees working in the sales department. The share options will vest at the end of year 3, provided that the employees remain in the entity's employ, and provided that the volume of sales of a particular product increases by at least an average of 5% per year. If the volume of sales of the product increases by an average of between 5% and 10% per year, each employee will receive 100 share options. If the volume of sales increases by an average of between 10% and 15% each year, each employee will receive 200 share options. If the volume of sales increases by an average of 15% or more, each employee will receive 300 share options.

On the grant date, entity A estimates that the share options have a fair value of 20 per option. Entity A also estimates that the volume of sales of the product will increase by an average of between 10% and 15% per year and therefore expects that, for each employee who remains in service until the end of year 3, 200 share options will vest. The entity also estimates, on the basis of a weighted-average probability, that 20% of employees will leave before the end of year 3.

By the end of year 1, seven employees have left and the entity still expects that a total of 20 employees will leave by the end of year 3. Hence, the entity expects that 80 employees will remain in service for the three-year period. Product sales have increased by 12% and the entity expects this rate of increase to continue over the next two years.

By the end of year 2, a further five employees have left, bringing the total to 12 to date. The entity now expects only three more employees will leave during year 3

and therefore expects a total of 15 employees will have left during the three-year period; and hence 85 employees are expected to remain. Product sales have increased by 18%, resulting in an average of 15% over the two years to date. The entity now expects that sales will average 15% or more over the three-year period, and therefore expects each sales employee to receive 300 share options at the end of year 3.

By the end of year 3, a further two employees have left. Hence, 14 employees have left during the three-year period, and 86 employees remain. The entity's sales have increased by an average of 16% over the three years. Therefore, each of the 86 employees receives 300 share options.

Application of Requirements

Year	Calculation	Remuneration Expense for Period	Cumulative Remuneration Expense
1	80 employees × 200 options × 20 × 1/3	106,667	106,667
2	(85 employees × 300 options × 20 × 2/3) – 106,667	233,333	340,000
3	(86 employees × 300 options × 20 × 3/3) – 340,000	176,000	516,000

Illustration of a Grant with a Service Condition and a Market Condition

At the beginning of year 1, an entity grants to a senior executive 10,000 share options, conditional upon the executive remaining in the entity's employ until the end of year 3. However, the share options cannot be exercised unless the share price has increased from 50 at the beginning of year 1 to above 65 at the end of year 3. If the share price is above 65 at the end of year 3, the share options can be exercised at any time during the next seven years (i.e., by the end of year 10).

The entity applies a binomial option model, which takes into account the possibility that the share price will exceed 65 at the end of year 3 (at which point the share options become exercisable) and the possibility that the share price will not exceed 65 at the end of year 3 (at which point the options will be forfeited). It estimates the fair value of the share options with this market condition to be 24 per option.

Application of Requirements

Because paragraph 21 of the IFRS requires the entity to recognize the services received from a counterparty who satisfies all other vesting conditions (e.g., services received from an employee who remains in service for the specified service period), irrespective of whether that market condition is satisfied, it makes no difference whether the share price target is achieved. The possibility that the share price target might not be achieved has already been taken into account when estimating the fair value of the share options at grant date. Therefore, if the entity expects the executive to complete the three-year service period and the executive does so, the entity recognizes the following amounts in years 1, 2, and 3: