

IFRS Link

March 2004

Issue Number 2

Welcome to the second edition of IFRS Link.

During November and December the International Accounting Standards Board ('IASB') issued 13 revised international standards as part of its improvements project. The revised standards, which cover a wide-range of subjects, apply for periods beginning on or after 1st January 2005, although earlier adoption is encouraged. At the same time IAS 15 'Information reflecting the effects of changing prices' was withdrawn.

The main aims of the IASB project is the improvement of the quality of certain existing standards and the reduction or elimination of permitted alternative accounting treatments within individual standards. The project has also been used as an opportunity to remove redundant items or conflicts within standards.

In this edition we are focussing on the key changes.

Future editions

In the next edition we will be looking specifically at the amended versions of IAS 32 and 39 which deal with all aspects of accounting for financial instruments. Both standards were issued in late 2003 and have 1st January 2005 application dates.

Other new standards which will be mandatory for periods beginning on or after 1st January 2005 will include the recently issued IFRS 2 'Share-based payments', the anticipated new standard dealing with business combinations (IFRS 3) and amendments to IAS 36 'Impairments' and IAS 38 'Intangible assets'.

IAS 1- Presentation of financial statements

IAS 1 sets out the basis of presentation of what it describes as 'general purpose financial statements'. Whilst these requirements are less prescriptive than those contained in the statutory requirements of a number of countries, they do form the basis for ensuring comparability with both the financial

statements of previous periods and with those of other entities.

The definition of materiality which is now included is as follows: 'Omissions or misstatements of items are material if they could, individually or collectively, influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size and nature of the omission or misstatement judged in the surrounding circumstances. The size or nature of the item, or a combination of both, could be the determining factor.'

Guidance as to the meaning of 'present fairly' has also been included and the standard emphasises that the application of IFRS is presumed to result in financial statements that achieve a fair presentation.

Clarification of the treatment of liabilities is provided and a financial liability which is due within 12 months of the balance sheet date should be classified as current even if an agreement to refinance, or re-schedule, on a long-term basis is made after the year end. Equally a long-term financial liability which has become payable on demand because of the breach of a loan condition should be classified as current, even if, after the year end, the lender has agreed not to demand repayment.

The disclosure of extraordinary items is now prohibited.

IAS 2 - Inventories

IAS 2 primarily provides guidance on the determination of the cost of inventories and their subsequent recognition as an expense.

Clarification has been provided in the revised standard as to which inventories are exempted from its requirements. The standard does not apply to the measurement of the inventories of agricultural and forest products, agricultural produce after harvest and minerals and mineral products, to the extent they are measured at net realisable value in accordance with recognised industry practice.

The amendments primarily focussed on

removing a number of measurement alternatives. The revised standard no longer allows the inclusion of foreign exchange differences in the cost of inventory and the use of the LIFO basis of valuation is now prohibited.

The standard has also included some additional new disclosure requirements, in particular disclosure of the amount of any write-down of inventories recognised as an expense in the period.

IAS 8 - Accounting policies, changes in accounting estimates and errors

IAS 8 was previously called 'Net profit or loss for the period, fundamental errors and changes in accounting policies'. Those aspects of the previous standard which dealt with the presentation of items in financial statements have been moved into IAS 1 (see above), and those parts of the previous version of IAS 1 dealing with accounting policies have been moved to this standard.

The concept of fundamental errors has been removed and adjustment to the comparative period is now required for all voluntary adjustments made as a result of the correction of material errors or changes in accounting policy. Previously the effects of changes in accounting policy could be dealt with either in the year of change or by adjustment of the comparative period. Whilst an exception to retrospective application continues to apply where it is impractical to do so, the standard now includes a specific definition of impractical.

Disclosure is now also required of the effects of an impending change in accounting policy as a consequence of a new standard that has yet to be implemented because it has been issued but not yet come into effect.

IAS 10 - Events after the balance sheet date

The limited amendment to this standard has provided additional clarification of the accounting treatment of dividends declared after the balance sheet date. The standard states that such dividends are not an

adjusting post balance sheet event and as such should not be accounted for as a liability. Disclosure is, however, required.

IAS 16 - Property, plant and equipment

IAS 16 deals with the principles applicable to accounting for tangible fixed assets and deals with recognition, determination of carrying value, depreciation and impairment.

The previous version of IAS 16 contained two separate recognition criteria, one for initial costs and one for subsequent costs. The revised standard now requires that all costs be evaluated at the time they are incurred irrespective of whether they are incurred on initial purchase or construction or incurred subsequently to add to, replace part of, or service an item.

The requirement to include within the cost of an item of plant, property or equipment the costs of dismantlement, removal or restoration has been extended to include not only where the obligation has arisen as a consequence of installing the asset, but also where it arises through use for purposes other than the production of inventories.

Where an item of property, plant or equipment is acquired in exchange for a non-monetary asset or assets, or a combination of non-monetary and monetary assets, it should be measured at fair value unless the exchange transaction lacks commercial substance. Previously, the cost of the asset would have been the carrying value of the asset exchanged.

It is still permitted to carry all items of property, plant and equipment of a class at revalued amount, but this is now restricted to those circumstances where the fair value can be measured reliably.

The definition of residual value has been altered to require the estimate to be based on the amount the entity could currently expect to receive for the asset if it were already at the age and condition expected at the end of its useful economic life.

Additional guidance on accounting for depreciation requires an item of property, plant or equipment to be depreciated from when it is available for use through to when it is derecognised, even if it is idle during part of that period.

IAS 17 - Leases

IAS 17 contains the accounting principles for determining whether a leasing arrangement constitutes a finance lease or an operating lease and the consequent

accounting treatments. Leasing is currently the subject of a far more wide-ranging IASB project and, therefore the amendments made as a result of the improvements project are fairly limited.

The revised IAS 17 makes it clear that in considering the classification of a lease of land and buildings, the land and buildings elements should normally be considered separately. Minimum lease payments should be allocated between the land and buildings elements in proportion to the relevant fair values. The land element is normally classified as an operating lease unless title passes to the lessee at the end of the lease term. The building element may be either an operating or finance lease and should be classified in accordance with the requirements of the standard.

Initial direct costs incurred by lessors are required to be added to the lease asset, except for manufacturer or dealer lessors. Initial direct costs are now defined. Costs of negotiating the lease are also added to the carrying amount and are recognised over the lease term.

IAS 21 - The effects of changes in foreign exchange rates

The standard deals with both accounting for transactions which are carried out in a foreign currency and also accounting for foreign operations. It provides guidance on which exchange rates should be used and how the effects of changes should be reflected in the accounts. The specific issues associated with hyperinflation are dealt with in IAS 29.

All material dealing with hedge accounting contained in the previous version of IAS 21 has been moved to IAS 39. IAS 39 will be one of two new international standards covered in the next edition of IFRS Link.

The concept of 'reporting currency' used previously in IAS 21 has been broken down into two elements:

- "'functional currency' which is the currency of the primary economic environment within which the entity operates and against which exchange differences are measured; and
- "'presentation currency' which is the currency in which the financial statements are presented and which can vary from the functional currency.

Functional currency is a matter of fact and the entity has no free choice in selecting it. Any changes in functional currency are required to be accounted for prospectively.

The distinction between integral foreign operations and foreign entities has been removed. As a result, those entities which were previously classified as integral, will have the same functional currency as the reporting entity. Only one translation method is now used for foreign operations - that which was previously applicable to foreign entities.

The revised standard also makes it explicit that goodwill and fair value adjustments arising on the acquisition of a foreign operation should be translated at closing rate.

IAS 24 - Related party disclosures

The possibility that the financial position or profit or loss of an entity might have been affected by the existence of related parties, is a matter that it is considered necessary to bring to the attention of the readers of financial statements. IAS 24 deals with the requirements for disclosure of such transactions.

The definition of related-party has been extended by adding parties who have joint control over the entity, joint ventures in which the entity is a venturer and post-employment benefit plans for the benefit of employees of the entity or of any entity that is a related party of the entity.

Disclosure is now required of the compensation of key management personnel, who are defined as those with the authority and responsibility for planning, directing and controlling the activities of the entity either directly or indirectly. The definition includes, but is not restricted to, all directors.

State-controlled entities have been brought within the scope of the standard and those who are profit-oriented are now required to disclose transactions with other state-controlled entities.

The standard also now requires disclosure of the entity's parent and, if different, the ultimate controlling party. If neither produce publicly available financial statements, the name of the next most senior parent that does so is required to be disclosed.

IAS 27 - Consolidated and separate financial statements

As the name of the standard would suggest, IAS 27 deals with the preparation of consolidated accounts. It also deals with accounting for investments in subsidiaries, jointly controlled entities and associates when separate financial statements are also

required.

In improving the standard the main aim has been to reduce the number of alternatives which were available under the previous standard. The name of the standard has been changed from 'Consolidated financial statements and accounting for investments in subsidiaries' to reflect the fact that it also deals with the separate financial statements of a parent, venturer or investor.

When determining whether the entity has power to control the existence of potential voting rights need to be taken into account.

The exemption from preparing consolidated accounts has been amended and now includes circumstances where 'the ultimate or any intermediate parent produces consolidated financial statements available for public use that comply with IFRS'. The definition of temporary control has been amended to require that temporary ownership should ordinarily be for a period of less than 12 months. In addition, it is no longer permitted to exclude from consolidation an entity under the control of the parent simply because it operates under long-term restrictions that significantly impair the ability to transfer funds to the parent.

For clarification, the standard now explicitly states that investments in subsidiaries that are venture capital organisations, mutual funds, unit trusts and similar entities must be consolidated.

Uniform accounting policies must always be used in preparing consolidated accounts, the previous exemption for circumstances when it was not practicable to do so has

been removed.

Minority interests must be included within equity.

IAS 28 - Investments in associates

The standard excludes investments that would otherwise be associates or interests of venturers in jointly controlled entities which are held by venture capital organisations, mutual funds, unit trusts or similar entities when they are classified as held for trading and accounted for in accordance with IAS 39.

Equity accounting is not required if the interest in the associate is acquired and held with the view of resale within twelve months. As with the exemption from consolidation of subsidiaries in IAS 27, evidence must exist that a buyer is being actively sought. It is no longer permitted to disapply equity accounting when the associate is considered to be operating under long-term restrictions.

Where the associate's accounts are prepared to a different date to the reporting entity, the gap cannot be more than three months. In addition, where the associate has different accounting policies to the reporting entity, adjustments should be made to align the accounting policies. The previous version of the standard allowed an exemption where the adjustment was 'not practicable'.

IAS 31 - Investments in joint ventures

The changes made to IAS 31 are consistent with those made to IAS 27 and IAS 28 discussed above.

IAS 33 - Earnings per share

The changes made are very limited and are restricted to the provision of additional guidance and illustrative examples on certain complex areas such as contingently issuable shares, potential ordinary shares in subsidiaries, written put options and mandatory convertible instruments. A number of illustrative examples have also been included.

IAS 40 - Investment property

IAS 40 permits a choice in accounting treatment for investment properties between a fair value model where all gains and losses are included within the profit and loss account or a cost model.

The amended standard now permits property interests held by lessees under operating leases to be treated as investment properties subject to certain conditions. It must meet the remainder of the definition of an investment property, the operating lease should be accounted for as if it is a finance lease under IAS 17 and the fair value model must be applied to the asset.

Where a valuation is adjusted significantly for the purposes of the financial statements, a reconciliation is required between the valuation obtained and the valuation in the financial statements.

For further details about the articles contained in this publication, please contact Yvonne Lang at:

Smith & Williamson/Nexia Audit Ltd, No.1 Riding House Street, London, W1A 3AS, UK.
tel: + 44 (0) 20 7637 5377, fax: + 44 (0) 20 7631 0741, email: yvonne.lang@smith.williamson.co.uk

