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Global

The Standards: IFRS 2013

An Investor's Audit Guide to IFRS Accounting

- Industry Overview

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- **3rd edition of our annual guide** — We provide an annual update on accounting developments which matter for investors, together with a summary of each IFRS/IAS outstanding. This year, we include a comparison of IFRS with US GAAP and Japanese GAAP to assist global investors.
- **Key topics for 2013** — The IASB is focused on completing major new standards on revenue recognition, leases, financial instruments, and insurance. We expect the new revenue standard to be issued during 2013, and we also expect updated Exposure Drafts on the other projects this year. The revenue standard may be particularly significant for the telecoms sector, while lease-financed sectors such as retail, transport and leisure will be affected by the leases project.
- **Focus on banks' accounting again** — The IASB will publish details of its new "expected loss" loan impairment rules for banks in Q1 2013, but these are expected to differ significantly from the recent FASB exposure draft. The previous incurred loss rules on loan impairment were criticised for contributing to the credit crisis (too little, too late) so investors and regulators will need to assess if the proposed new rules better reflect economic reality.
- **Pensions still an issue**— Corporate pension exposure is likely to remain in focus this year due to lower discount rates resulting in significantly higher pension liabilities, and the revised IAS 19 pension standard taking effect from Q1 2013.
- **Standard by standard guide** — This report provides an overview of each IFRS for investors, highlighting valuation implications and potential problem areas.

See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Accounting Issues for 2013

IASB needs to deliver on key projects during 2013

The International Accounting Standards Board (IASB) has had another disappointing year. As we noted last year, the Board failed to deliver its new standards on revenue accounting, leases, financial instruments and insurance on schedule, and we are still waiting. Moreover, it seems that the IASB's dream of the US adopting IFRS standards is dead, or at least deferred for a long time. However, with the US convergence project drawing to a close, we think that the IASB will have to make some tough decisions in 2013.

Less focus on US now

During 2012, the SEC issued its final staff report considering incorporation of IFRS into the US financial reporting framework (ie adoption of IFRS in place of US GAAP for US companies). The report failed to provide any recommendation on adoption of IFRS. The drive for IFRS adoption in the US has lost momentum and we do not expect the US to adopt IFRS in the near or medium term. Furthermore, when the current convergence projects have been completed (expected during 2013/14), IFRS and US GAAP convergence will no longer be a priority.

New revenue IFRS promised in 2013

For 2013, we expect the IASB to focus on the major projects of revenue recognition, leases, financial instruments and insurance. The new revenue IFRS is likely to be published in 2013 (the IASB is currently targeting H1), with an effective date of 2015 or later. We have highlighted in previous research the potential impact of revenue standard on the telecoms and aerospace & defence sectors.

Leases draft expected soon

We expect a further Exposure Draft on leases shortly (Q1 2013). Although the IASB still appears committed to bringing leases on balance sheet, there has been a substantial debate about the appropriate P&L treatment. Industries affected include retail, transport and leisure. It is unclear if the IASB and FASB will be able to converge on this topic and we also do not expect the final standard to take effect until 2016 at the earliest.

More focus on banks' accounting again

We think there will be a further focus on banks' accounting during 2013. The IASB is going to publish its updated proposals on financial instrument impairment soon, but we expect this to differ substantially from the FASB's proposed "expected loss" impairment model in December 2012. The current IAS 39 "incurred loss" impairment method has been much criticised for impairments being "too little, too late" during the credit crisis. The new model is intended to result in earlier loss recognition, but we are not convinced it will result in significantly more transparent and comparable reporting.

Finally, corporate pension exposure is likely to remain relevant to investors during 2013. The amended IAS 19 will increase reported pension expense for some companies, while currently low discount rates will result in higher gross pension liabilities in 2012 accounts.

Comparisons with US GAAP and Japanese GAAP on pages 74-76

From page 15, we provide our annual summary guide to each IFRS and IAS in issue at January 2013. We summarise the main points of each standard and flag up relevant issues for investors, such as forthcoming changes, weaknesses in the standard, useful disclosures, how to incorporate the accounting data in company valuation, or choices in the standard which can affect comparability of company results. We also include a comparison of IFRS and US GAAP on page 74, and a comparison of IFRS and Japanese GAAP on page 76.

New Accounting Rules Effective in 2013/14

No major new accounting standards were issued during 2012, but standards issued in 2011 will take effect in 2013 and 2014, as discussed below.

Pensions (Post-Employment Benefits)

New pension rules apply from Q1 2013

An amended version of IAS 19 ("IAS 19 R") was issued in June 2011, which should be effective for accounting periods starting on or after 1 January 2013. For more details of IAS 19 R, see page 49.

We believe there are two changes which will be significant for investors: the abolition of the "corridor" rule and a change to the calculation of the P&L charge for pensions.

Abolition of the "corridor" rule

Abolishing "corridor" affects airlines sector

Until now, IAS 19 has permitted a choice of pension accounting. Pension deficits could be fully marked-to-market on the balance sheet, or the "corridor" rule allowed for smoothing by leaving some pension gains/losses off-balance sheet. IAS 19 R abolishes the corridor alternative, so that all companies will report any pension deficit on balance sheet. This will affect a significant minority of European companies by reducing book value materially, particularly in the airlines sector. The new standard should simplify analysis as the pension deficit will be on the balance sheet rather than hidden in the notes to the accounts.

Change to P&L cost

P&L change lowers earnings on average

Until now, the pension cost in the P&L included the expected return on pension assets, less the interest cost on pension liabilities. The revised IAS 19 replaces this with a notional interest charge on any pension deficit or surplus. This will generally reduce earnings, because companies normally assume the expected return on pension assets is higher than the pension discount rate. Companies most affected will be those with the largest funded pension schemes relative to company market cap, and those with the riskiest asset allocation, typically mainly in the UK.

Implications

Some companies may exclude pension costs from adjusted earnings

Since, on average, pension costs charged to the P&L will increase as a result of this accounting change, we suspect that some companies will seek to exclude the financial element of the pension cost (the notional interest charge on the pension deficit) from adjusted earnings figures. We disagree with this; we believe that a company with a pension deficit should report higher pension costs than an otherwise identical company with no pension deficit.

Companies may look to reduce pension risk

Finally, IAS 19 R may encourage some companies to investigate ways of reducing pension risk (and therefore balance sheet volatility), such as buy-outs, buy-ins, longevity swaps or asset-liability matching. We discussed these techniques in *Pension Perspectives: Q3 2012 - Review of Pension Risk Management* (17 October 2012).

For an updated list of companies which may be affected by the transition to IAS 19 R, please contact us.

Joint Ventures (IFRS 11)

JV standard effective from 2014

IFRS 11 was issued in May 2011, with an effective date of accounting periods starting on or after 1 January 2013. However, the EU has delayed endorsement of IFRS 11 and the related consolidation standards (IFRS 10 and IFRS 12), so they will not be mandatory for EU companies until 2014.

We believe IFRS 11 may have significant impact on groups with material jointly controlled entities accounted for under the proportional consolidation method. Current IFRS allows a choice between proportionate consolidation and the equity method for these JV entities. IFRS 11 will not allow proportionate consolidation in many cases where it is currently used.

Wider use of equity method likely

This is likely to result in more widespread use of the equity method in JV accounting. The equity method means that investments are initially measured at cost, and adjusted for the owners' share of the change in the net asset value of the partially owned entity, with the share of income recorded in one line of the P&L; this is the accounting method used for associates (investments over which the group has significant influence but not control or joint control). Only dividends received are included in the cash flow statement. With proportionate consolidation, the group includes its share of the JV assets, liabilities, income and expenses, and cash flows, line-by-line in the financial statements.

Potentially negative impact on affected companies

Since the accounting policy of proportionate consolidation is a choice at present, it is likely that, in many cases, changing to the equity method may give a less favourable impression of the results, cash flow or financial position (eg lower sales, lower margins, lower cash flow, or higher net debt). However changing from proportionate consolidation to the equity method will have no effect on EPS or net asset value.

For more details see our report *The Standards: New IFRS on JVs*, dated 13 May 2011.

Financial Instruments Offsetting – New Disclosures

New disclosures on banks' derivatives netting from Q1 2013

From Q1 2013, banks will have to provide new disclosures about financial instruments offsetting. This should allow investors to make better comparisons of US and European banks' balance sheets and leverage ratios. This is due to a revision of IFRS 7 (Financial Instruments: Disclosures).

US GAAP and IFRS have different rules determining the extent to which financial assets and financial liabilities can be offset (netted off) on the balance sheet. This particularly affects the netting of derivative assets and liabilities, and to a lesser extent repos/reverse repos and brokerage receivables/payables. US GAAP generally allows more offsetting than IFRS. As a result, a European bank appears more leveraged than an otherwise identical US bank.

From Q1 2013, both US and European banks will have to provide quantified information about the "fully gross" and "fully netted off" positions. We discussed this in our recent note *US & European Wholesale Banks - New Netting Disclosure, Focus on Leverage* (7 December 2012).

Fair Value Measurement

New guidance on fair value measurement may improve consistency of banks' accounting

From 2013, companies will have to apply IFRS 13: Fair Value Measurement for the first time. This standard does not cover which items should be measured at fair value, but provides guidance on how fair value should be determined. To a large extent, this new standard merely confirms existing best practice. However, in some cases we expect IFRS 13 may affect reported numbers. For example, some banks may need to change their practices for measuring derivative liabilities (we discussed this in our recent note *The Standards: November Update (*7 November 2012).

Consolidation Rules

New rules governing consolidation not a major change

IFRS 10: Consolidated Financial Statements largely confirms the existing requirements for determining which entities should be consolidated. For example, it confirms that some entities may be controlled even if the parent company's voting share is below 50%. Since it is largely a clarification of the previous rules, we do not expect a major impact on companies. IFRS 12: Disclosure of Interests in Other Entities requires additional disclosures about consolidation (for example, why a 50% owned company has not been consolidated), which may be useful for investors in some cases, provided the information provided is meaningful and not "boilerplate". Both these standards, like IFRS 11, will be mandatory in the EU from 2014.

The relevant standards, IFRSs 10-13, are summarised on pages 30-34.

Major IASB Projects: Where do we stand?

The IASB is working on four major projects. These are:

- **Revenue** – replacing existing rules on when revenue is reported
- **Leases** – bringing all leases on balance sheet
- **Financial Instruments** – complete replacement of IAS 39 (identified as a high priority following the credit crisis)
- **Insurance** – first comprehensive IFRS for insurance

Major delays and failure to converge with US GAAP

These four projects were not delivered on schedule (the final standards were originally expected in 2011), but we expect significant progress this year. The delays reflect considerable difficulties in reaching agreement with the US Financial Accounting Standards Board (FASB), as the two boards have been attempting to produce converged standards. We do not expect any of the resulting IFRSs to be mandatory before 2015, at the earliest. We also do not expect that the final standards will achieve full convergence with US GAAP.

Nevertheless, the topics are sufficiently important that we think investors should continue to monitor developments. We outline the current state of play below.

Revenue Recognition

New revenue accounting standard effective 2015 or later

This standard will replace the existing IAS 11 and IAS 18 (see pages 41 and 48). The IASB has published two Exposure Drafts (EDs), one in 2010 and an updated version in November 2011. We expect a final IFRS to be issued in 2013 (the IASB is timetabling it for H1, although this looks slightly optimistic to us). The IASB has stated that the effective date will be no earlier than 1 January 2015, but we believe 2016 is more likely.

What will change?

Aim to improve revenue accounting consistency under IFRS and comparison with US GAAP

At present, revenue recognition rules are set out in two separate standards (and some related interpretations). It is not always clear which standard should be applied and this may result in different companies accounting for similar transactions in different ways. This can result in different revenue and profit profiles (though this is generally a timing issue – eventually the same revenue is reported whichever accounting method is used).

In addition, there are considerable differences between IFRS and US GAAP rules on revenue accounting. US GAAP has many sources of accounting guidance on revenue, including industry-specific requirements. This reduces the comparability of US and European company results. The IASB and FASB are trying to develop one converged standard for recognising revenue consistently.

The ED introduces the concept of '**performance obligations**' as the key drivers of revenue recognition. The ED defines performance obligations as "*a promise in a contract with a customer to transfer a good or service to the customer*". This in effect means that revenue is recognised when a customer takes ownership of a good or the output of a service. We have outlined the key points of the proposed accounting model in Figure 1.

Figure 1. Overview of proposed revenue recognition framework based on 2011 ED

Step	Notes
Identify the contract(s) with the customer	■ Identification of the enforceable rights and obligations of contracts ■ Companies may combine contracts if part of a package deal or involve only one performance obligation
Identify separate performance obligations in the contract	■ Contracts involving multiple distinct performance obligations (transfer of distinct goods or services) should be accounted for separately ■ A distinct good or service is one that is regularly sold separately by the company (competitors selling the good separately not considered)
Determine the transaction price	■ The payment expected to be received for contract completion ■ Variable or non-cash consideration valued at either expected value or best estimate (most predictive method to be selected) ■ Contract price adjusted for time value of money if significant
Allocate the transaction price	■ Transaction price allocated over separate performance obligations ■ Division on basis of distinct selling prices, or estimated relative value of obligations if necessary
Recognise revenue as performance obligations are satisfied	■ Recognise revenue for each performance obligation when customer obtains control of that good or service ■ Point in time revenue recognition for goods, gradual recognition over time for services ■ Cumulative revenue recognition limited to the amount a company is reasonably assured to be entitled to

Source: IASB, Citi Research

The framework is somewhat abstract; but this appears necessary in attempting to create a 'one size fits all' revenue recognition model for the first time. Two types of contract may be most affected:

1. Bundled contracts

Bundling refers to the sale of more than a single good or service (performance obligation) within a contract, and is often a combination of a good and service. Under the ED proposals, unless the good and service are indistinct[1], revenue should be recognised for each separate element of the contract independently, based on the **standalone selling prices** (or estimated relative value of elements for which a standalone selling price is not available) of each element.

2. Long-term contracts (including provision of services)

Percentage of completion accounting still allowed in most cases

The revenue project was originally expected to discontinue percentage of completion accounting and cause major changes to the accounting for long-term contracts, potentially allowing revenue recognition only on completion of a project in some cases. However, the 2011 ED permits revenue recognition gradually over time (rather than at specific points in time when performance obligations are fulfilled) if one of the following two criteria is met:

- The company must **create or enhance an asset that the customer controls**, or
- The company **does not create an asset with an alternative use**, and must also meet one of three criteria, the most relevant of which is that the entity has a **right to payment for performance completed to date**. This must at least compensate the company for activity to date (not contract termination compensation), and the company must expect to fulfill the contract as promised

[1] For the elements of a contract to be considered indistinct the company must provide a significant service integrating the goods and/or services into the combined item sold. An example is of a software license sold to a customer alongside a service contract to significantly modify that software to the customer's specification.

In general it seems like that these criteria will continue to allow percentage of completion accounting for many construction and other long-term contracts.

The ED proposals would also bolster the disclosure requirements relating to revenue recognition, with the objective of providing meaningful specific information on the judgments and estimates made in this area. Examples of proposed new requirements include:

- A reconciliation of the movement in working capital balances to the reported revenue figure, providing a closer link between the P&L and balance sheet.
- Details of the expected future revenue recognition pattern for contracts exceeding one year which are in progress at the balance sheet date.
- Increasing the level of disclosure required in interim reports.

Which companies will be affected?

Companies in telecoms and technology sectors may be affected

Companies with bundled contracts would have to account for the components of the contract based on the standalone selling prices. This could affect companies selling combined goods and services, for example in the technology or telecoms sectors. For example, mobile telephone operators selling a service contract together with a free or discounted handset will probably have to book revenue initially based on the market value of the handset, whereas at present revenue recognition is usually on a cash basis. In this case, revenue recognition is likely to be earlier than under previous practice.

Construction companies and others with long-term contracts may be affected by the new standard; however, the revised ED appears to continue to allow percentage-of-completion accounting in many cases. We therefore do not expect widespread major changes for these sectors. However, additional disclosure requirements may be helpful for investors.

The new revenue standard may have greater impact in the US, as it will replace numerous sources of industry-specific guidance.

Leases

New Leases ED expected in 2013

A Lease Exposure Draft was issued in August 2010. We previously published a detailed report on the implications of these proposals[2]. The IASB is currently re-deliberating this project with an updated Exposure Draft expected in Q1 2013. Although no official date has been set, we do not expect the final IFRS until 2014 and we think that it will not be mandatory until 2016 at the earliest.

What will change?

Leases to be brought on balance sheet

The final version of the standard is uncertain pending the publication of a revised ED. However, we expect that the final standard will retain the key point of the 2010 ED, that leases will be reported on balance sheet (with a “right of use” lease asset and a lease liability). However, we think the implications for P&L treatment may differ compared to the initial draft.

All leases on balance sheet, but two P&L treatments

Under the latest proposals, there would be two possible P&L and cash flow statement presentations for leases longer than 12 months. For some leases, the lease expense would be recognised on a straight line basis (as with current

[2] *Bringing Leases on Balance Sheet - Proposed Elimination of Operating Lease Accounting*, dated 18 August 2010.

operating leases) while for any other leases, depreciation and interest charges would be recorded separately (as with current finance leases), generally with a front loaded expense profile. For property leases the default treatment would be straight line recognition in the P&L, unless the lease term represents the major part of the asset's life or the lease payments account for substantially all of the fair value of the leased asset. For all other assets the default would be current finance lease accounting, unless the lease term is an insignificant portion of the economic life of the underlying asset, or the fixed lease payments are insignificant relative to the asset's fair value.

The proposals for cash flow statement presentation follow the P&L: if the lease qualifies for straight line P&L recognition then the cash lease payments would be recognised as operating cash flows. If finance lease P&L presentation is required, then the cash lease payments would be split and allocated between interest payments (either operating or financing cash flows under IFRS) and capital payments (financing cash flows).

New standard set to increase reported leverage and affect many key metrics such as EV/EBITDA

We expect that lessees using operating leases will be affected as follows:

- Higher reported leverage, as operating lease commitments would be capitalised on balance sheet and included as financial obligations
- Changes to metrics such as EV/EBITDA, although case-by-case impact
- In some cases, significant differences between P&L expense and cash lease payments

In our view, the IASB's current thinking is questionable, both theoretically and practically. Keeping two types of lease accounting (with respect to P&L treatment) might be confusing for investors and potentially lead to accounting arbitrage. From a theoretical perspective, if the IASB believes that all leases (longer than 12 months) are financing transactions requiring debt to be reported on balance sheet, then in our view it is inconsistent not to report a corresponding interest expense, or amortisation of the lease asset. From a practical perspective, this could distort commonly used financial ratios and calculations, such as EV/EBITDA or average interest rate calculations.

Which companies will be affected?

Affects retail, transport and leisure

Most exposed sectors include retail, transport and leisure. For a list of exposed stocks, please contact us.

Financial Instruments

Replacement of IAS 39

The IASB already issued parts of IFRS 9, on the classification and measurement of financial assets and liabilities and the reporting of "own credit" gains on financial liabilities, during 2009 and 2010. It has since reconsidered some aspects of the classification and measurement of assets in an ED published in Q4 2012 (see IFRS 9 on page 28).

Expected loss loan impairment proposals expected shortly

However, a critical part of the project on impairment rules (which would apply to assets measured at amortised cost or debt instruments measured through Other Comprehensive Income) has not yet been resolved. This is important as IAS 39's current "incurred loss" provisioning requirements were regarded by many commentators as contributing to the 2008 credit crisis, ie loan impairments were "too little, too late". A revised ED for impairment rules is expected in Q1 2013,

which is likely to introduce a more forward-looking "expected loss" provisioning model.

Differences between IASB and FASB impairment models

The US FASB recently (December 2012) issued its own proposals on financial instrument impairment. The FASB's ED would require banks to recognise the full lifetime expected loss on a loan on "day 1" (issuance). We expect the IASB will propose a different impairment rule: only 12 month expected losses would be recognised initially, with a switch to recognition of lifetime losses after a trigger of "significant deterioration" in the credit quality of the loan or other financial asset. We have identified problems with both the FASB's and IASB's impairment proposals as discussed recently in *The Standards: January Update* (7 January 2013).

IFRS 9 as currently issued is summarised on page 28. The whole standard is currently scheduled to be mandatory in 2015, already delayed from 2013, although we believe further delay is almost inevitable given the project's importance and difficulty. Clearly this standard is particularly significant for banks and insurers.

Insurance

A comprehensive standard for Insurance - eventually

The IASB issued an Exposure Draft on Insurance Contracts in July 2010. A further ED is expected during 2013. We do not expect the final standard to be issued until 2014 or effective until 2018.

At present there is no comprehensive IFRS for insurance (see page 22 for a summary of IFRS 4), so there is inconsistency in reporting amongst insurance companies applying IFRS. This reduces comparability of results and arguably may lead to insurance companies suffering a valuation discount.

A full review of the insurance project is outside the scope of this report, but the insurance ED proposed a building blocks approach to measuring insurance liabilities, taking into account:

- the expected cash flows (probability weighted) of the contract
- the time value of money
- a risk adjustment (quantifying the difference between the certain and uncertain liability)
- a residual margin (quantifying the unearned profit arising from the contract that will be earned as the contract is fulfilled)

Effect of discount rate changes on insurance liability outside P&L

This means insurance liabilities will be measured at a present value which will vary as market conditions such as interest rates vary. However, we expect the IASB will now propose that remeasurements of the insurance liability due to changes in the discount rates will be presented in Other Comprehensive Income, ie not affecting net income (as initially proposed in the 2010 ED).

Global Adoption of IFRS

More than 90 countries require IFRSs for listed companies

Figure 2 shows the current status of IFRS adoption for listed companies in various markets globally. IFRS adoption makes it easier for investors to compare companies in different countries, and provides a common accounting language.

Figure 2. Status of IFRS adoption in various countries

Country	IFRS Status for Listed Companies	Country	IFRS Status for Listed Companies
All EU + EEA countries[1]	Mandatory to use IFRSs as adopted by EU	Mexico	Mandatory
Argentina	Mandatory	Morocco	Mandatory for financial institutions, permitted for others
Australia	Mandatory (IFRS equivalent standards)	New Zealand	Mandatory (IFRS equivalent standards)
Bahrain	Mandatory	Nigeria	Mandatory
Brazil	Brazil standards aligned with IFRS but not full adoption	Oman	Mandatory
Canada	Mandatory	Pakistan	Pakistan standards based on IFRS
Chile	Mandatory	Panama	Mandatory
China	China standards based on IFRS	Peru	Mandatory
Colombia	IFRS permitted from 2013, to be required from 2015	Philippines	Philippines standards based on IFRS
Egypt	Egypt standards based on IFRS	Qatar	Mandatory
Hong Kong	HK standards almost identical to IFRS	Russia	IFRS or US GAAP required for largest listed companies; IFRS permitted but not required otherwise
India	IFRS based standards published but no effective date set	Saudi Arabia	Required for banks and insurers. Not permitted otherwise
Indonesia	Indonesia standards based on IFRS as of 2009	Singapore	Singapore GAAP partially converged with IFRS
Israel	Mandatory except for banks/dual registrants	South Africa	Mandatory
Japan	Permitted for some but not mandatory	Switzerland	Main Standard registrants must use IFRS or US GAAP[2]
Jordan	Mandatory	Taiwan	Required from 2013
Kazakhstan	Mandatory	Thailand	Not permitted. Full convergence with IFRS expected by 2015
Kenya	Mandatory	Turkey	Mandatory
Korea	Mandatory	Ukraine	Mandatory
Kuwait	Mandatory	United Arab Emirates	Mandatory
Lebanon	Mandatory	USA	Not permitted except for foreign filers
Malaysia	Malaysia standards almost identical to IFRS		

Source: PwC, E&Y, Deloitte, Citi Research. Notes: [1] EU: Austria, Belgium, Bulgaria, Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, Netherlands, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, UK. EEA: Iceland, Liechtenstein, Norway.
[2] Swiss GAAP is a permitted alternative for companies listed under the Domestic Standard.

Some Swiss companies, including Swatch, have given up IFRS to revert to "more practical" Swiss GAAP

The IASB may be slightly alarmed that since 2008, about 20 Swiss companies have reverted to using Swiss GAAP rather than IFRS. Although most of these have been small-cap companies, Swatch (market cap c. CHF 27bn) has also reverted to Swiss GAAP, arguing that this is "more practical and less theoretical" than IFRS[3]. Switzerland is unusual within Europe in not requiring IFRS. Swiss listing rules require companies listed under the Main Standard to use IFRS or US GAAP, but Swiss GAAP is a permitted alternative for companies listed under the Domestic Standard. It is unclear at this stage if other Swiss companies may follow Swatch's lead. EU listed companies would not be able to revert to local GAAP due to an EU-wide requirement to use IFRS since 2005.

US

No US decision on adopting IFRS

The SEC staff issued a report about IFRS in 2012, which notably lacked a recommendation or timeframe to adopt IFRS in the US. We do not expect the US to adopt IFRS in the foreseeable future.

Little to show for convergence efforts

The IASB and US FASB have been working to converge IFRS and US GAAP for several years, but have little to show for their efforts so far. Of the remaining major joint projects, we think it is unlikely that full convergence will be achieved for the

[3] For more details on Swatch's move, see *The Standards: November Update*, dated 7 November 2012.

leases, financial instruments or insurance projects. It is possible the two Boards will be able to achieve largely converged revenue standards. Once these projects are completed, it seems clear that both boards will pursue separate agendas.

We provide a comparison of US GAAP and IFRS in Appendix 1 on page 74.

Japan

Japan unlikely to require IFRS soon but voluntary IFRS adoption permitted

Japan has also delayed its decision on mandatory IFRS adoption, and we do not expect IFRS to be required in Japan for many years (not before 2016 at the very earliest, most likely some years later). However, Japan already permits international companies to use IFRS, and a few companies have already switched to IFRS, with more expected[4].

We provide a comparison of Japanese GAAP and IFRS in Appendix 2 on page 76.

Local versions of IFRS

Different versions of IFRS

Unfortunately many countries have not adopted an identical set of IFRS standards but have made local adjustments. For example, companies listed in the European Union have to use IFRS “as adopted by the EU”. In practice the set of EU-endorsed IFRSs is almost the same as full IFRS, with the exception of a specific element of IAS 39 applicable to some banks. In addition the EU endorsement process takes some time, so companies are sometimes not allowed to use issued IFRSs despite the IASB permitting early adoption (eg IFRS 9). The EU also sometimes delays the effective date of new standards (eg IFRS 10, 11 and 12).

China standards based on IFRS but not the same

Some countries have adopted accounting standards which are based on IFRS but which are not the same. For example, China’s accounting standards, though similar to IFRS, have differences such as not permitting the fair value model for property, plant and equipment (IAS 16) or intangibles (IAS 38), and not permitting the reversal of impairment charges (IAS 36). India is also considering requiring listed companies to use Indian standards with some differences from IFRSs (eg investment companies required to use the cost model and not permitted to use the fair value model in IAS 40), but no implementation timeline has been set out. Other countries which apply IFRS based standards with local amendments include Brazil, Egypt, Pakistan and the Philippines.

Inconsistent interpretation or application of IFRS

Further, even where countries require “full IFRS”, the standards are not necessarily appropriately applied by all companies, or they may be interpreted inconsistently in different countries. There is no international enforcement of accounting requirements.

Greek debt write-downs illustrated lack of comparability of IFRS results

This problem was clearly illustrated in 2011 when EU listed banks and insurers took different approaches to Greek sovereign debt impairment. Some argued that Greek government bonds were not impaired in Q2 and Q3 2011. Even when Available-for-Sale bonds *were* impaired, some companies wrote them down to market price while others used very different model-based valuations – although the latter approach was criticised by the IASB Chairman. For example, UK and German companies mainly applied market prices while French companies tended to use model-based valuations.

[4] Japanese companies which have adopted IFRS include DeNA, Japan Tobacco, Nippon Sheet Glass Co, Nihon Dempa Kogyo and Hoya.

This may limit the benefits of IFRS adoption and reduce comparability. There is a possible brand risk to IFRS standards if some companies claim to apply IFRS fully but in practice do not. Some academic evidence suggests that the possible benefits of IFRS adoption (improved liquidity, valuation ratios, lower cost of equity) arise only in countries with stronger accounting enforcement[5].

The IASB has noted that it has "an interest in the proper application of our standards" and in future it will do more to try to address problems of inconsistent application[6]. For example, it will work more closely with regulators and its Interpretation Committee may take a more active role in shaping the use of IFRS in practice. However, the IASB has no formal role in enforcing IFRSs, and we are sceptical that the IASB's proposed actions will improve the overall quality of IFRS accounts significantly. Within the EU, it is possible that the European Securities and Markets Authority (ESMA) may take a more active role in enforcing IFRS consistency, which we would welcome.

IFRS label is no guarantee of quality

In other words, investors should not assume that all IFRS reporting companies apply the same standards consistently or that the IFRS "label" guarantees high reporting quality.

[5] Eg see review of academic evidence in "*The European IFRS Experiment: Objectives, Research Challenges and some Early Evidence*" by P. Pope, S. McLeay.

[6] For example, *Financial Times* article "IASB pushes for uniform accounting rules", 10 February 2012.

IFRS: Standard by Standard

Guide to IASs and IFRSs

In this report we provide a short guide to each standard issued by January 2013, listed in Figure 3. International Financial Reporting Standards (IFRSs) have been issued since 2001 by the IASB. International Accounting Standards (IASs) were issued by its predecessor body the IASC. No new standards or major revisions were issued in 2012, although some new or revised standards take effect from 2013 (eg IFRS 13, revised IAS 19) or 2014 (eg IFRS 10-12).

Figure 3. List of International Financial Reporting Standards at January 2013

IFRS 1	First-time Adoption of International Financial Reporting Standards
IFRS 2	Share-based Payment
IFRS 3	Business Combinations
IFRS 4	Insurance Contracts
IFRS 5	Non-current Assets Held for Sale and Discontinued Operations
IFRS 6	Exploration for and Evaluation of Mineral Resources
IFRS 7	Financial Instruments: Disclosures
IFRS 8	Operating Segments
IFRS 9	Financial Instruments
IFRS 10	Consolidated Financial Statements
IFRS 11	Joint Arrangements
IFRS 12	Disclosure of Interests in Other Entities
IFRS 13	Fair Value Measurement
IAS 1	Presentation of Financial Statements
IAS 2	Inventories
IAS 7	Statement of Cash Flows
IAS 8	Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10	Events after the Reporting Period
IAS 11	Construction Contracts
IAS 12	Income Taxes
IAS 16	Property, Plant and Equipment
IAS 17	Leases
IAS 18	Revenue
IAS 19	Employee Benefits
IAS 20	Accounting for Government Grants and Disclosure of Government Assistance
IAS 21	The Effects of Changes in Foreign Exchange Rates
IAS 23	Borrowing Costs
IAS 24	Related Party Disclosures
IAS 26*	Accounting and Reporting by Retirement Benefit Plans*
IAS 27	Consolidated and Separate Financial Statements
IAS 28	Investments in Associates
IAS 29	Financial Reporting in Hyperinflationary Economies
IAS 31	Interests in Joint Ventures
IAS 32	Financial Instruments: Presentation
IAS 33	Earnings per Share
IAS 34	Interim Financial Reporting
IAS 36	Impairment of Assets
IAS 37	Provisions, Contingent Liabilities and Contingent Assets
IAS 38	Intangible Assets
IAS 39	Financial Instruments: Recognition and Measurement
IAS 40	Investment Property
IAS 41	Agriculture

Source: International Accounting Standards Board. *Note: we have not included IAS 26 in this report because it only relates to reporting by pension schemes, ie it does not affect company accounts.

We include a brief overview of each standard and its implications for investors, such as how the information may be incorporated into valuation or any weaknesses we see in the standard (such as flexibility or choices which may reduce comparability

across companies). Obviously this is not intended as a substitute for reading the full standard. For more details or if you have any specific questions, please contact us.

Interpretations (IFRICs) = guidance on detailed technical points

The IASB's International Financial Reporting Interpretations Committee (IFRIC) issues interpretations of specific technical issues which supplement the guidance in the standards. We have not described each IFRIC (called SICs for interpretations pre 2001), but have mentioned them if we think they may be significant for an investor's understanding of a particular standard.

Throughout this report for convenience we use the terms "profit and loss account" (P&L) for the income statement (sometimes now combined with other comprehensive income in one statement of comprehensive income) and "balance sheet" for what the IASB now refers to as the statement of financial position. Similarly, we refer to minority interests for what are now called non-controlling interests. Finally, we use the terms "company", "group" or "entity" to refer to the reporting entity being analysed.

IFRS 1: First-time Adoption of IFRSs

How to adopt IFRS and minimum required disclosures

This standard sets out the rules for a company adopting IFRS for the first time, ie the extent to which IFRSs should be applied retrospectively or prospectively. This could be important in countries which are adopting IFRS from 2013 onwards.

Main Points of the Standard

When a company applies IFRS for the first time, it prepares an opening IFRS balance sheet for the start of the first comparative year; for example, companies adopting IFRS in (calendar) 2005 had an opening IFRS balance sheet as of 1 January 2004.

The opening IFRS balance sheet is prepared in accordance with IFRS, ie as if IFRS had always been applied, except for certain simplifying exemptions. These include:

- Previous acquisitions do not have to be restated as if IFRS 3 had applied (eg goodwill previously written off to reserves is not restated)
- Fair value may be used as "deemed cost" for property, plant and equipment on transition

In addition IFRS 1 sets out the minimum information which companies have to provide when adopting IFRS, such as reconciliations of equity and comprehensive income between the previous GAAP and IFRS. IFRS 1 only requires one year of comparative figures in the financial statements (although national regulations may require more).

Issues for Investors

First-time adoption choices may flatter balance sheet or earnings

Investors should be aware that IFRS 1 permits various choices (such as revaluing fixed assets which do not have to be revalued in future) which may allow companies to flatter the opening balance sheet or future earnings. Over time these effects should fade.

In addition, IFRS 1 only requires relatively limited reconciliation between old GAAP and IFRS. In practice many companies provided more than the permitted minimum information when they adopted IFRS.

IFRS 2: Share-based Payment

Shares and options paid to employees have to be expensed through P&L

IFRS 2 covers the expensing of shares and options granted to employees (as well as other share-based payments). Prior to 2005, when this standard was introduced, employee share options were normally expensed at intrinsic value (ie zero expense if the option strike price was set to the current share price).

Main Points of the Standard

Costs spread over the vesting period

The fair value of shares or options granted to employees should be expensed through the P&L. If the share-based payment has a vesting period, the expense is charged to the P&L evenly over the vesting period.

Options measured at fair value using any reasonable valuation model

The fair value of employee options may be estimated using any reasonable model, if no market price is available (typically employee options are granted subject to conditions so there are no equivalent traded options). The model must take into account specified factors: exercise price, current share price, expected volatility, life of option, expected dividends, and the appropriate risk-free interest rate, and any other factors which a knowledgeable market participant would consider. Companies typically use a Black-Scholes model or a binomial model.

Fair value is measured at date of grant and not re-measured subsequently

The fair value is estimated at the date of grant and in most cases the fair value is not re-measured. However, in the case of cash-settled share-based payments, the expense is re-measured at each reporting date.

Many employee options schemes have vesting conditions, typically that the employee has to work for the company for the vesting period or the options/shares are forfeited. The expense is calculated by reducing the fair value of the options/shares granted by the amount which is not expected to vest[7]. Once estimated, this expense is then spread over the vesting period. Although the fair value is not re-measured, the vesting assumptions are re-assessed at each reporting period.

Example: A company grants options with a fair value of £5m and a vesting period of 4 years. It is anticipated initially that 20% of the options will not vest, due to the employee leaving before the end of the vesting period. The annual P&L expense will be 80% x £5m / 4 years, ie £1m per annum, assuming the original assumption on vesting proportion does not change.

Issues for Investors

Do not strip this expense out of "adjusted" EPS

Impact on EPS: Share-based payments are typically significant for technology companies, some media companies, and some younger/growth companies. Many companies in the technology sector (and a few others) exclude share-based payments from adjusted earnings metrics. We disagree with this exclusion as we see the options or shares distributed as a form of employee pay, and so a normal business expense. Further, it is a recurring adjustment which is dilutive to existing shareholders, as discussed in previous research[8].

DCF valuation should incorporate future option grants and options currently outstanding

Impact on DCFs: Investors also ask us how these options should be captured in Discounted Cash Flow (DCF) valuations. In our view, future estimated cash flows being discounted should take into account the total expected employee cost, even if some of the remuneration may be paid in the form of shares or options. In addition the fair value of already outstanding options, if material, should be estimated and

[7] This applies for most vesting conditions. Certain types of vesting conditions (market conditions, eg a share price target) are taken into account when estimating the fair value of the options.

[8] *Adjusted Earnings - A Review of Non-GAAP EPS in Europe*, dated 8 November 2010.

deducted (like debt) from the calculated enterprise value when estimating the equity value of the business. Of course in the actual reported cash flow statement, options expense is a non-cash figure, although cash inflows may arise from the exercise of options (employees paying the strike price to the company).

Review key assumptions if expense is highly material

Sensitivity to assumptions: The calculation of options expense depends on various significant assumptions (such as future dividend payments, share price volatility, proportion of options which will not vest due to employees resigning, etc) and so if the expense is material these assumptions should be reviewed. Changes in the assumed proportion of options which will vest can affect the P&L charge materially (eg if a catch-up adjustment is made) but unfortunately these assumptions are usually not disclosed.

Tax treatment is complicated

Tax: The tax treatment of options expense can be complicated. Some tax authorities (eg in the UK) give a corporate tax deduction for the value of the options when they vest rather than at the date of grant. If the share price has increased, the tax deductible options cost may be larger than the P&L options cost. This tax effect is shown in the statement of other changes in equity rather than in the P&L. As a result the P&L tax and the cash tax may diverge.

For more details on the accounting rules relating to deferred employee shares or options, see our recent report *Deferred employee compensation: A primer for equity investors*, dated 7 November 2012.

IFRS 3: Business Combinations

Current standard on M&A effective since 2010

IFRS 3 was revised fairly recently as part of convergence with US GAAP (although the resulting standards are not fully converged). This version of IFRS 3 was mandatory for annual periods beginning on or after 1 July 2009, ie 2010 for calendar year-ends. This affected the treatment of contingent consideration (earn-outs), step acquisitions, and acquisition related costs.

Main Points of the Standard

Acquired assets and liabilities measured at fair value; difference between price paid and net assets is goodwill

The **acquisition method** is applied to all business combinations. Pooling of interest/merger accounting is not permitted. An acquirer must be identified. The assets and liabilities of the acquired business are measured at fair value (with certain exceptions), including certain intangible assets (such as value of customer relationships, etc) which were not previously recognised on the acquiree's balance sheet. Goodwill is the difference between the price paid for the acquisition and the fair value of the net assets acquired.

Assets and liabilities which are not measured at fair value on acquisition include deferred tax assets and liabilities (measured in accordance with IAS 12) and pension deficits/surpluses (measured in accordance with IAS 19). Minority interests can be measured either at fair value or at the share of the acquiree's net identifiable assets (ie excluding the minority interest goodwill). In practice few companies opt for fair value measurement of the minority interest[9].

Earn-outs now subsequently marked-to-market

The price paid for the acquisition is determined on the acquisition date - this is important if payment is in shares rather than cash. The acquisition date is the date the acquirer obtains control. The price paid includes the estimated fair value of contingent consideration ("earn-outs"). Subsequent changes in the value of the contingent consideration are usually marked-to-market through the P&L. This is a change to the previous version of IFRS 3 when such costs were treated as goodwill adjustments.

Negative goodwill booked as gain in P&L

If the price paid is less than value of the net assets acquired, known as a bargain purchase, the resulting gain is recognised in the P&L. This is sometimes called "negative goodwill".

Sometimes an acquisition is achieved in stages (a step acquisition). For example, a company may own 20% of an associate company and then buy the remaining 80%. When control is obtained, typically on obtaining the majority of the voting power, the previously held stake is revalued and a gain or loss is recognised in P&L. Many investors find it counterintuitive that a gain or loss is recognised on the associate stake when it has not been sold and the gain or loss only reflects the new transaction price for buying a further stake.

Final figures can take up to a year

Sometimes the acquirer cannot complete all the acquisition accounting by the next reporting date. Estimates may be used and adjustments can be made for up to one year from the acquisition date as the full information becomes available.

Acquisition related costs such as lawyers' fees must be expensed in the P&L (although many companies exclude these costs from adjusted earnings measures). Prior to the IFRS 3 revision, these costs were capitalised in goodwill.

[9] The previous IFRS 3 did not permit fair value measurement of minority interests. US GAAP now requires minority interests in new acquisitions to be measured at fair value.

If a minority interest is bought out by the group, the difference between the price paid and the book value of the minority interest is adjusted in equity, ie written off to reserves.

Issues for Investors

Acquisition accounting can be opaque and cloud the underlying performance of businesses. We suspect the amendments to IFRS 3, which took effect in 2010, made this problem worse.

Fair value write-downs can increase future reported profits

Fair value write-downs: The acquirer re-states the acquiree's balance sheet to fair value. If the value of acquired assets is lowered, or liabilities increased, as part of this fair value exercise, future profits are increased (for example, writing down fixed assets will lower future depreciation charges). The other side of such adjustments is an increase to goodwill but, since goodwill is no longer amortised, this has no P&L impact, unless goodwill becomes impaired.

The previous version of IFRS 3 required companies to present both the book value and the fair value of the acquiree's balance sheet at the acquisition date, so investors could see any write-downs. The current version of IFRS 3 only requires disclosure of the fair values, so it may be harder or impossible to identify fair value write-downs on acquisition which may flatter future earnings. In our view this removes an important market discipline. Of course companies can, and often do, still choose to provide the book value information, in the interests of transparency.

Step acquisitions can result in P&L profit

Gain/loss on buying more shares: Under the new IFRS, buying more shares so that an associate becomes a subsidiary can result in a gain or loss in the P&L. This gain or loss may not be clearly disclosed at the time and so may distort underlying profit trends.

Earn-out mark-to-market impact may seem counterintuitive

Earn-outs marked-to-market: The treatment of contingent consideration may lead to counterintuitive results. This can be significant for technology and media companies, particularly advertising agencies. For example, if an acquired subsidiary is performing well, the change in value of the earn-outs may result in a large cost, which could far outweigh the reported better performance. In other words, good performance of an acquired business may result in lower profits. In practice some companies and investors remove the earn-out mark-to-market from "adjusted earnings". In some cases the earn-outs may be effectively paying for the services of the former owners who continue to work in the business, so the underlying cost should not be ignored.

Watch out for goodwill write-off to reserves on purchase of minority interest

Write-off minority goodwill to reserves: The accounting treatment for the purchase of minority interests may reduce shareholders' equity significantly (if the fair value of the minority interest is more than book value), which could distort Return on Equity calculations.

Gains from negative goodwill represent low quality earnings

Gain on bargain purchase: Some investors have concerns about gains on bargain purchases (negative goodwill), which they view as low quality earnings (one-off gain highly dependent on management estimates/judgment). These profits should be clearly disclosed and excluded from adjusted earnings measures, in our view.

IFRS 4: Insurance Contracts

Insurance industry lacks a proper IFRS

IFRS 4 does not provide a comprehensive framework for accounting for insurance business. Introduced in 2005, it was intended as an interim standard to reduce the diversity of insurance accounting practices. The IASB is working on a new standard but has made slow progress.

Main Points of the Standard

IFRS 4 permits numerous inconsistent accounting practices

IFRS 4 exempts insurance contracts from other IFRSs. Companies are permitted to continue to use the accounting policies which they used prior to adoption of IFRS 4 (eg local GAAP or US GAAP) with certain exceptions. IFRS 4 therefore permits many inconsistent accounting practices, eg:

- Insurance liabilities may be measured on a discounted or undiscounted basis
- Discount rates for insurance liabilities may reflect expected investment returns or a more prudent rate may be used
- Insurance liabilities may be remeasured to reflect changes in market interest rates, but they do not have to be
- Companies may choose to apply “shadow accounting”[10]
- Companies may use non-uniform accounting policies for insurance contracts of subsidiaries

IFRS 4 imposes a “liability adequacy test”, ie companies must check at each reporting date that the recognised insurance liability is adequate, using current estimates of cash flows expected under the insurance contracts. IFRS 4 requires certain minimum disclosures about insurance contracts.

Issues for Investors

Lack of comparability may cause share price discount

It is plainly unsatisfactory that there is no comprehensive accounting standard for insurance contracts. As a result accounting practices vary considerably amongst European insurers and therefore key investment metrics, whether based on earnings or book value, are not comparable across companies. Many companies apply some aspects of US GAAP in the absence of detailed IFRS guidance. It is possible that European insurance companies’ shares trade at a discount due to the perceived lack of transparency.

Unfortunately, the IASB has made slow progress with its insurance accounting project. It expects to issue an updated Exposure Draft in H1 2013.

[10] Shadow accounting: In some accounting models, realised gains/losses on an insurer’s assets have a direct effect on measurement of the insurance liabilities. Shadow accounting permits all recognised gains/losses on assets to affect the measurement of insurance liabilities in the same way, regardless of whether (a) the gains/losses are realised or unrealised and (b) unrealised gains/losses are recognised in profit or loss or in other comprehensive income.

IFRS 5: Non-current Assets Held for Sale and Discontinued Operations

Discontinued operations are stripped out of P&L

This standard determines when parts of businesses can be treated as discontinued operations. This is important because discontinued operations are stripped out of the main P&L and presented separately.

Main Points of the Standard

Non-current assets (or a "disposal group" of assets, including subsidiaries) are classified as **held for sale** if the carrying amount is expected to be recovered principally through sale rather than continuing use in the business. The sale must be "highly probable", ie management must be committed to a plan to sell, actively marketing the asset/group, and the sale should be expected within one year.

Such assets are measured at the lower of the carrying amount and fair value less costs to sell. They are not depreciated. Assets and liabilities of a disposal group are shown separately from other assets and liabilities in the balance sheet.

Discontinued operation must be major line of business or region

A **discontinued operation** is part of the business which either has been disposed of or is classified as held for sale, and which meets one of the following criteria:

- Major line of business or geographical area of operations
- Part of a coordinated plan to dispose a major line/geographical area of business, or
- Subsidiary acquired exclusively with a view to resale

The results of a discontinued operation are presented as a single amount in the P&L, which is a combination of the post-tax profit or loss of the operation and any post-tax gain or loss on disposal or on measurement to fair value less costs to sell. This amount is analysed into the revenue, expenses, pre-tax profit, tax, any pre-tax gain/loss and the associated tax, but this analysis may be presented in the notes. The net cash flows attributable to the operating, investing and financial activities of the discontinued operation must also be disclosed.

Issues for Investors

Classifying businesses as discontinued may flatter headline EPS figure

Investors may have some concerns that companies can use the classification of a business as a discontinued operation as a way of excluding losses or poor performance from the main part of the P&L and from a "continuing EPS" figure. In some cases, businesses may continue to be classified as discontinued even if they are not sold within a year.

Although stripping discontinued businesses out of the main part of the P&L may help investors forecast the results of the continuing business, the performance of the discontinued business should not be forgotten as this affects total cash flows and returns to shareholders. In addition, stripping out poorer performing businesses as discontinued may give a flattering impression of the group's overall performance.

Measuring businesses held for sale at fair value less costs to sell may be helpful for sum-of-the-parts valuations.

IFRS 6: Exploration for and Evaluation of Mineral Resources

Limited accounting guidance for extractive industries

This is a limited standard and as a result investors may see divergence in accounting practices amongst companies in the extractive industries.

Main Points of the Standard

Standard only covers exploration and evaluation costs

The standard only applies to exploration and evaluation expenditures but not to other aspects of accounting by companies in this sector. Exploration and evaluation assets are measured initially at cost. The standard gives examples of costs which might be included in calculating these assets, such as acquisition of rights to explore, geological studies, exploratory drilling, and other activities relating to evaluating the technical feasibility and commercial viability of mineral extraction.

After initial recognition, exploration and evaluation assets are measured using either the cost model (ie cost less depreciation/amortisation and any impairment) or the revaluation model (ie regularly revalued to fair value).

Issues for Investors

No IFRS guidance on reserves

Current IFRS does not contain any guidance on calculating reserves and resources, although various jurisdictions provide specific codes. These estimates are used in the calculation of various figures in the accounts, such as depreciation, amortisation, impairment, provisions for site rehabilitation, and stripping costs. Reserves and resources figures depend on important assumptions such as commodity prices.

Inconsistent capitalisation

Different companies may not capitalise the same costs within exploration and evaluation assets. Since some companies in extractive industries capitalise a higher proportion of their costs than others, return on capital comparisons may be distorted.

In April 2010, the IASB published a Discussion Paper, *Extractive Activities*, but this project has since been effectively discontinued. In 2011 the IASB's Interpretation Committee, IFRIC, issued new guidance on the accounting for stripping costs[11] to address the current diversity in practice in this specific area.

[11] IFRIC Interpretation 20: *Stripping Costs in the Production Phase of a Surface Mine*, issued October 2011. Stripping is the removal of mine waste materials to access mineral deposits. For more details on IFRIC 20 see *The Standards: November Update* (8 November 2011).

IFRS 7: Financial Instruments: Disclosures

Mandatory disclosures about financial instruments

This is a disclosure-only standard: it does not affect actual accounting, only what information must be provided about financial instruments. It was issued in 2005 (replacing IAS 30 and parts of IAS 32) and became mandatory in 2007. It has been amended subsequently in response to the credit crisis. The IFRS 7 disclosures are intended to inform investors about both the importance of financial instruments to a company and the potential risks arising from them.

Main Points of the Standard

IFRS 7 applies to all financial instruments, apart from exceptions such as investments in subsidiaries, associates and joint ventures (covered by IAS 27, IAS 28 and IAS 31); instruments arising from pension plans (IAS 19), insurance contracts (IFRS 4) and share-based payments covered by IFRS 2. It applies to all companies, not just banks.

Disclosures required by IFRS 7 include:

- Financial assets and liabilities by accounting category (eg fair value through P&L, available for sale, held to maturity)
- Disaggregated information about financial income, expense and impairment
- Details of any reclassifications between accounting categories
- The fair value of each class of financial asset and liability so this can be compared with the carrying amount
- Fair values categorised as level 1 (quoted prices), level 2 (fair value based on observable inputs) or level 3 (based on unobservable inputs)
- Information about assets pledged or held as collateral
- Qualitative and quantitative information about cash flow hedges and fair value hedges
- Credit risk information, including analysis of assets past due or impaired
- Liquidity risk information, including maturity analysis of financial liabilities
- Market risk information, including sensitivity analysis for each type of market risk, or that reflects interdependencies (eg value-at-risk)

The IASB recently added additional disclosures about the offsetting of financial assets and liabilities (eg netting derivative assets and liabilities), effective from 2013. This follows an unsuccessful attempt to converge IFRS and US GAAP rules on offsetting (US GAAP allows more offsetting of derivative assets and liabilities than IFRS, reducing comparability of banks' balance sheets). For more information on this new requirement, see our recent note *US & European Wholesale Banks - New Netting Disclosure, Focus on Leverage*, dated 3 December 2012.

Issues for Investors

Importance of fair value disclosures highlighted in credit crisis

Information such as the fair value hierarchy (instruments categorised into levels 1, 2, and 3) received considerable attention during the credit crisis[12]. Similarly, some IFRS 7 disclosures may be useful in assessing exposure to sovereign debt or country specific exposures. The quality of information provided varies between banks, but generally compliance has been improving, probably partly due to greater attention from regulators. Most IFRS 7 disclosures are only required annually so the infrequency and delay in reporting may reduce the value of the information to investors, although amendments to IAS 34 (Interim Financial Reporting) require updates in interim reports in some circumstances.

New information on netting will help leverage comparisons

The additional information on offsetting from 2013 should enable investors to compare US and European banks' leverage ratios on a more consistent basis. This disclosure will also be required in interim reports.

[12] In fact the level 1/2/3 fair value hierarchy was a US requirement but not an IFRS requirement during 2007/08 – IFRS 7 was amended to include this disclosure in 2009.

IFRS 8: Operating Segments

Segment reporting standard takes "through eyes of management" approach

This standard became mandatory in 2009. It largely adopted the segment disclosure requirements of US GAAP (SFAS 131) into IFRS. It is a disclosure-only standard. While the previous segment reporting standard IAS 14 was more prescriptive, IFRS 8 emphasises presenting information as seen "through the eyes of management".

Main Points of the Standard

An operating segment is a component of the business which engages in business activities to earn revenues and whose operating results are regularly reviewed by the **chief operating decision maker** (eg CEO or board) to make decisions about resource allocation and to assess performance. Operating segments may be combined if they have similar economic characteristics and the segments are similar in respect of products and services, types of customer, production process and distribution.

Segment information must be provided if the resulting operating segment or combination of segments meets a 10% threshold for revenue, profit or loss or assets. Segments not meeting the thresholds can be combined in an "other segments" category, but this category cannot exceed 25% of total revenues.

Segment profit does not have to be an IFRS figure

Companies must report a measure of profit or loss for each reportable segment[13]. Other items are required if regularly reported to the chief operating decision maker or if included in the measure of segment profit or loss, including

- Revenues (internal and external)
- Total assets and liabilities
- Depreciation and amortisation
- Material items disclosed in accordance with IAS 1 (ie exceptional items)

Geographic disclosure is only required for revenues and for non-current assets (at least for the home country and other material countries). The company must also disclose whether any customers represent more than 10% of revenues, though it does not have to disclose their identity.

Issues for Investors

IFRS 8 has the advantage of being consistent with internal management information, but may reduce comparability between companies.

What does segment information say about company management?

Investors should consider if it is reasonable for the company to manage the business on the basis of the disclosed segmentation and the chosen profit measure. Some companies still only disclose one segment, which may be reasonable for a smaller or simple business but probably not for a complex international group.

Overall the switch from IAS 14 to IFRS 8 has had less impact than expected. The IASB is currently conducting a post-implementation review of IFRS 8 although we do not expect this to result in any substantive changes to the standard.

[13] This can be a non-GAAP measure of profit. However reconciliation of total segment profit to an IFRS profit measure such as profit before tax is required.

IFRS 9: Financial Instruments

Successor to IAS 39 not yet in use in Europe

*IFRS 9, which has not yet been finalised, will eventually replace IAS 39. The published effective date is 1 January 2015 (although this may be delayed), but early adoption is permitted. However, the EU has not yet endorsed IFRS 9, so **no EU listed companies can use it yet**. We do not expect EU endorsement until a complete version of IFRS 9 has been issued.*

Main Points of the Standard

IFRS 9 is being issued in sections covering the classification and measurement of financial assets and liabilities, impairment rules for financial assets, and hedge accounting requirements.

The rules on classification and measurement have already been published, although to confuse matters further these are currently being amended (an Exposure Draft with the proposed amendments was issued in November 2012). New rules on the impairment of financial assets are currently being developed, with an Exposure Draft expected in Q1 2013.

We summarise below the parts of IFRS 9 which have already been issued.

The new classification and measurement rules for financial assets specify two possible categories for debt instruments: amortised cost, or fair value through P&L (However, the recent ED would allow a third category of fair value through Other Comprehensive Income).

Debt instruments will be measured at amortised cost if

- The business model is to hold them for collection of contractual cash flows
- The contractual terms give rise to cash flows on specified dates that are solely payments on principal and interest

New category for equities

All other instruments will be measured at fair value through P&L, with one limited exception for some equities. Equities may be held at fair value through Other Comprehensive Income (OCI) if an irrevocable election is made to this effect when the equity asset is first recognised, and it is not held for trading. Equities held at fair value through OCI are shown at fair value on the balance sheet; dividends are reported in the P&L but all other gains or losses are recognised in OCI, whether or not they are realised. For details of the current accounting for amortised cost instruments or those at fair value through P&L, see IAS 39 (page 69).

The IFRS 9 classification of financial assets is summarised below in Figure 4.

Figure 4. IFRS 9 Classification of Financial Assets

Category	Includes	Accounting
FV through P&L	Default category, including all derivatives	Marked to market through P&L
Fair value through OCI	Equities (only if companies make election)	FV on balance sheet. Dividends through P&L.
Amortised cost	Debt instruments meeting business model and cash flow criteria	Amortised cost

Source: IASB, Citi Research

Possible change to previous decisions

The IASB recently published an ED reconsidering some aspects of the IFRS 9 classification and measurement rules, which proposed a further category of debt instruments at fair value through OCI. This is considered necessary for convergence with the FASB's classification and measurement model, and also due

to interaction with the insurance project. For more details see our recent report *New financial instruments accounting - Available for Sale category granted a reprieve*, dated 30 November 2012.

Addressing "own credit" gains and losses

The accounting for financial liabilities in IFRS 9 is largely unchanged from IAS 39, apart from an exception relating to liabilities measured at fair value through P&L due to a fair value option. The change in fair value in these liabilities which arises from own credit risk will be recognised in other comprehensive income (in IAS 39 the whole movement in fair value is recognised in P&L).

Issues for Investors

At present this standard is generally not in use and we do not expect many companies to apply IFRS 9 until it becomes mandatory in 2015 or later. However, we see several important issues for investors:

More bonds at amortised cost

Amortised cost vs fair value: We believe that IFRS 9 allows greater flexibility for quoted bonds to be measured at amortised cost. Under IAS 39, bonds quoted in an active market can only be measured at amortised cost if they are held to maturity, which is highly restrictive, whereas IFRS 9 will allow bonds to be measured at amortised cost if the business model and contractual cash flow tests are met. In our view, this will typically result in less useful information for investors because for quoted bonds we believe the market price is the most value-relevant information.

Some realised gains/losses excluded from P&L

New accounting for equities: The new Fair Value through OCI category for equities is in our opinion likely to cause some confusion for investors because some realised gains or losses (on the sale of equities) will never be recognised in the P&L.

One-off restatements: When companies adopt IFRS 9 for the first time, it may result in a significant restatement of balance sheets (some assets being reclassified from fair value to amortised cost and vice versa).

Impairment rules: New rules on loan impairments will be particularly important for banks. A revised impairment proposal is expected to be published shortly (Q1 2013).

Can IASB/FASB converge?

Convergence: The IASB and FASB had been asked to converge their accounting standards for financial instruments. However, this has been largely unsuccessful to date. In particular the IASB and FASB have so far developed different impairment models.

IFRS 10: Consolidated Financial Statements

IFRS 10 (issued 2011) is not yet mandatory. It is expected to replace much of the guidance in IAS 27 in 2014, and makes minor changes to the rules concerning consolidation of subsidiaries.

Main Points of the Standard

EU delayed effective date to 2014

IFRS 10 was published during 2011 as part of a suite of standards (IFRSs 10-12) governing how to account for beneficial interests in other entities. IFRS 10 will replace most of IAS 27 when it becomes mandatory. Although the IASB issued IFRSs 10-12 with an effective date is 1 January 2013, this has been delayed to 2014 by the European Union.

IFRS 10 requires entities to be consolidated if they are controlled. Control is defined as having rights to variable returns from involvement in the investee entity and the ability to affect those returns through the company's power over the investee. The change in emphasis from previous guidance is subtle but intended to counter inconsistencies in current practice. It also eliminates the two previous different sources of consolidation guidance in IAS 27 and SIC 12 (SIC 12 applied to special purpose vehicles and focused on “risks and rewards” of ownership as an indicator of control).

In particular IFRS 10 explicitly states that an entity may control another entity with less than 50% of voting rights (eg if 48% is owned and the other shares are widely held by many shareholders). This was not so explicit in IAS 27, and so the new standard may change some consolidation practices. In addition, IFRS 10 states that substantive potential voting rights should be considered when assessing control (even if they are not currently exercisable).

Issues for Investors

Consolidation will remain a judgmental area

While IFRS 10 clarifies when an entity should be consolidated, this remains a judgmental area, and we do not expect that IFRS 10 will eliminate all inconsistencies in current practice.

IFRS 12 includes revised disclosures which require companies to comment on the specifics of consolidation decisions. We think these disclosures will be important for investors to review in the case that material businesses are consolidated if ownership is less than 50%, or not consolidated if ownership is over 50%. See page 33 for more detail on IFRS 12.

IFRS 11: Joint Arrangements

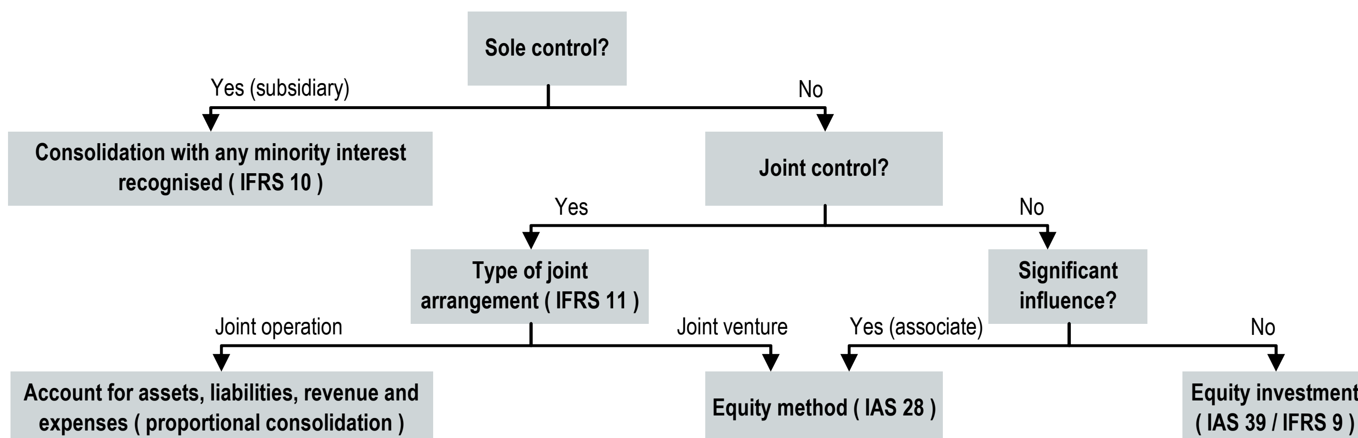
IFRS 11 was published in 2011 and is not yet mandatory in the EU. It applies when a company has joint control over an entity, operation or asset and will replace IAS 31. The new standard may have significant impact on some companies with JVs that are currently proportionately consolidated.

Main Points of the Standard

Part of package with IFRS 10 and IFRS 12

IFRS 11 will replace IAS 31, and will apply to joint arrangements. In the EU it will be mandatory from 2014 (2013 elsewhere). It does not affect the accounting for entities which are controlled but not wholly owned (ie subsidiaries with minority interests). The new rules form part of a wider overhaul of accounting for the various forms of beneficial ownership, as summarised in Figure 5.

Figure 5. IFRS accounting treatment decision tree for subsidiaries, joint arrangements and associates



Source: IASB, Citi Research

IFRS 11 distinguishes between joint operations, when the reporting company is exposed to the rights and obligations of the underlying assets and liabilities of a joint arrangement, and joint ventures, when it has rights to the net assets of the joint arrangement. The equity method will be required for joint ventures. In most cases, joint arrangements that are companies (ie separate legal entities) will be joint ventures and proportionate consolidation will no longer be permitted.

More widespread use of equity method for JVs

This is likely to result in more widespread use of the equity method in JV accounting. The equity method means that investments are initially measured at cost, and adjusted for the owners' share of the change in the net asset value of the partially owned entity, with the share of income recorded in one line of the P&L; this is the accounting method used for associates (investments over which the group has significant influence but not control or joint control). With proportionate consolidation, the group includes its share of the JV assets, liabilities, income and expenses, and cash flows, line-by-line in the financial statements.

Issues for Investors

Potential negative impact of adopting IFRS 11

Since the accounting policy of proportionate consolidation is a choice at present, it is likely that, in many cases, changing to the equity method may give a less favourable impression of the results, cash flow or financial position (eg lower margins, lower cash flow, or higher net debt). However changing from proportionate consolidation to the equity method will have no effect on EPS or net asset value.

Potential impact on valuation and leverage ratios

We expect that ratios such as EV/EBITDA and gearing may be affected by the accounting changes. However, as companies do not generally disclose net debt figures for JV entities, it is not yet currently possible to estimate the extent of the impact.

Some companies (eg in the oil industry) use joint arrangements involving jointly controlled assets, which we expect may be classified as joint operations under the new standard, and may therefore continue to be consolidated proportionately.

The accounting changes are accompanied by disclosure requirements, which will require companies to present summarised financial information for each joint venture that is material to the company (see IFRS 12). We expect that some companies may also choose to prepare adjusted financial information with JVs proportionately consolidated in analyst presentations, for example.

It is possible that the new accounting rules may affect the way that some joint arrangements are structured, if companies wish to obtain a particular accounting outcome.

IFRS 12: Disclosure of Interests in Other Entities

IFRS 12 (issued 2011) is not yet mandatory. It specifies disclosure requirements for subsidiaries, joint arrangements, associates, and unconsolidated structured entities.

Main Points of the Standard

IFRS 12 was published alongside IFRS 10 and IFRS 11, and contains disclosure requirements intended to assist investors:

- Understand management judgements in classifying the company's involvement with other entities (eg decisions about consolidating companies in which the group has a large ownership stake)
- Understand minority (non-controlling) interests
- Assess the nature of risks associated with interests in other entities
- Evaluate the effects of interests in other entities on the financial statements, and estimate the value of investments in other entities

More information about judgements associated with consolidation decisions

Current IFRS requires disclosure of entities consolidated without 50% voting control, or entities which are not consolidated despite ownership of 50% of voting rights. The reasons why these entities are treated as they are is also required. However, these requirements were seen as insufficient in light of the financial crisis of recent years. IFRS 12 requires disclosure of the significant judgments and assumptions made in determining the scope of consolidation, including any changes to those judgments and assumptions. These requirements apply to all entities in which a company has an interest (ie subsidiaries, associates, JVs and non-consolidated entities).

IFRS 12 will also require companies to present more financial information about subsidiaries and related minority interests, as well as joint ventures and associates. Of particular interest to investors may be the new requirements to disclose the cash and debt held in material JVs, as well as dividends received from such JVs.

Like IFRS 10 and IFRS 11, IFRS 12 is mandatory in the EU from 2014 (the IASB set an effective date of 2013).

Issues for Investors

IFRS 12 should, in theory at least, provide useful insight into consolidation decisions which require management judgement. The 2008 financial crisis highlighted the importance of disclosure in this area, as many special purpose vehicles were not consolidated (particularly under US GAAP), and greater disclosure could offer some protection for investors.

IFRS 13: Fair Value Measurement

This standard (effective 2013) defines fair value and sets out the IFRS framework for measuring fair value and the required disclosures. It is intended to converge with US GAAP requirements.

Main Points of the Standard

Guide to determining fair value

IFRS 13 does not cover *which* assets and liabilities should be measured at fair value; instead, it sets out *how to* determine fair value. It takes effect from 2013. It does not change current practice materially in most cases but centralises guidance and disclosure requirements for the measurement of assets and liabilities at fair value. Fair value rules were previously spread across a number of IFRSs as new standards were created, and IFRS 13 is intended to increase consistency, and to converge the US GAAP and IFRS rules in this area.

Fair value is defined as "*the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date*"[14] ie an exit price. Fair values are based on quoted prices in active markets where possible, but three means of valuation may be used under the fair value hierarchy, as shown in Figure 6.

Figure 6. Fair value hierarchy

Level	Definition
Level 1	Quoted prices in active markets for identical assets and liabilities. Level 1 inputs must be used without adjustment whenever available.
Level 2	Inputs not included within Level 1 that are observable for the asset or liability, either directly or indirectly.
Level 3	Unobservable inputs, including the entity's own data, which are adjusted if necessary to reflect market participants' adjustments.

Source: IASB

Issues for Investors

Fair value accounting remains controversial

Fair value accounting continues to be a controversial area of accounting, particularly for the financial sector. Fair value measurement, particularly in illiquid markets, can be subjective and therefore companies may reach different conclusions in valuing the same assets. The fair value hierarchy provides some visibility of the nature of valuations, but what is more difficult is to assess whether management judgements have been balanced, conservative, or otherwise. IFRS 13 does offer the benefit of reconciling US GAAP and IFRS rules, but fair value measurement is a challenging area and is likely to continue to be so.

2013 adoption of IFRS 13 may affect valuations of some instruments

The adoption of IFRS 13 in 2013 may be a catalyst for some banks to adjust their valuation methodologies for some financial instruments[15], such as OTC derivative liabilities. Although the IASB intended companies to incorporate the impact of own credit risk on the value of financial liabilities under IAS 39, practice has been inconsistent. IFRS 13 plainly requires companies to incorporate non-performance risk (including a company's own credit risk) into financial liability valuation. IFRS 13 also makes clear that assessment of the impact of credit risk should be on the basis of current market inputs, another area of inconsistency in current practice.

[14] IFRS 13 paragraph 9.

[15] For more details, see *The Standards: November Update*, dated 7 November 2012 (from page 4).

IAS 1: Presentation of Financial Statements

Basic framework for financial statements

This standard sets a framework for what constitutes a complete set of financial statements in IFRS. For example it specifies what (minimum) line items should be included in each financial statement. It also describes the general features of financial statements: ie fair presentation and compliance with IFRSs, prepared on an accrual basis, etc.

Main Points of the Standard

IFRS financial statements must contain:

- Statement of financial position (balance sheet)
- Statement of comprehensive income either as two statements (income statement and statement of comprehensive income) or one statement
- Statement of changes in equity
- Statement of cash flows
- Notes, including disclosure of accounting policies, the most significant accounting judgements and major sources of estimation uncertainty

Operating profit not required or defined

The P&L must include line items for revenue, finance costs, associates/JVs using the equity method, tax, discontinued operations, profit or loss. Operating profit is not a required line item, because operating profit is not defined in IFRS. Expenses may be analysed (in the P&L or in the notes) either by nature of expense (eg raw materials, employee costs, depreciation, etc) or by function of expense ("cost of sales" method).

Exceptional items not defined

The term "exceptional items" is not used in IFRSs, but material items such as write-downs, restructuring charges, and property gains/losses should be disclosed separately.

The balance sheet must contain certain specified line items and must present current and non-current assets and liabilities separately. Requirements for the cash flow statement are set out in IAS 7.

"True and fair override" exists, but extremely rare

IAS 1 also states that if in "extremely rare circumstances" management concludes that compliance with an IFRS would be so misleading that it would conflict with the objective of financial statements, it may depart from the requirement. This is sometimes known as a "true and fair override". We are aware of only a few instances of this amongst listed European companies.

Issues for Investors

Lack of prescription causes problems in practice

The IAS 1 requirements are not very prescriptive which means reduced comparability of key metrics such as operating margin. For example, pension costs may be classified within operating costs or split between operating and financial costs. The failure to define exceptional items also leads to wide variation in practice.

IAS 2: Inventories

This standard sets out how to value inventories (often called stock in the UK).

Main Points of the Standard

Inventories at lower of cost and NRV

Inventories are measured at the lower of cost and net realisable value (NRV). NRV is the estimated selling price less costs of completion and sale. Cost may be determined on a first-in, first-out (FIFO) basis or at weighted average cost. Last-in, first-out (LIFO) is not permitted in IFRS though it is permitted in US GAAP.

Costs of inventories include an allocation of fixed (eg depreciation) and variable (indirect materials and indirect labour) production overheads. In times of high production, the amount of fixed overhead allocated to each unit of production is reduced so that inventories are not measured above cost. At low production, the fixed overhead allocation is not increased. Any unallocated overheads are charged to the P&L.

Inventory write-downs may be reversed subsequently.

Issues for Investors

LIFO not permitted

The use of FIFO accounting means that balance sheet figures are current, but in some circumstances LIFO (which is not permitted in IFRS) may give a better indication of current profitability. Differences between LIFO and FIFO will be greater in times of inflation.

Overhead absorption effects may affect profitability at times of high or low production. Inventory write-downs are sometimes classified as “exceptional charges” but this can flatter the underlying profit record.

IAS 7: Statement of Cash Flows

IAS 7 sets out requirements for the cash flow statement, which reconciles the opening and closing cash position, and categorises cash flows into operating, investing and financing.

Main Points of the Standard

Cash flows classified operating/investing/financing; can be direct or indirect presentation

The cash flow statement reports cash flows classified into operating, investing and financing activities. Operating cash flows may be presented directly (eg cash in from customers, cash out to suppliers) or indirectly (profit or loss adjusted for non-cash items).

Lack of standardisation

IAS 7 is relatively un-prescriptive about cash flow classifications. For example, interest and dividends paid may be classified as operating or financing and interest and dividends received may be classified as operating or investing.

If a joint venture is proportionately consolidated, then the cash flow statement includes the proportionate share of the JV's cash flows. If a JV is accounted for using the equity method, only dividends received are recognised.

The cash flow statement reconciles the opening and closing total of cash and cash equivalents. Cash equivalents are "short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value".

IAS 7 requires disclosure of any cash or cash equivalents that are not available for use by the group eg due to legal restrictions, exchange controls, etc.

Issues for Investors

Inconsistent starting point

In Europe, almost all cash flow statements are presented using the indirect method, ie reconciling profit to cash flow from operating activities. Some companies start from net income while others start from operating profit (or another profit measure), which can be confusing and reduce comparability.

No net debt reconciliation

One major frustration for investors is the **lack of reconciliation to net debt**. Although the cash flow statement reconciles the movement in cash, other changes (such as currency translation and the effect of acquisitions on debt) can affect the net debt movement. Some companies provide a reconciliation of net debt but this is not mandatory. Note that net debt is not a defined term in IFRS so net debt figures are not necessarily comparable (eg whether to include derivative assets/liabilities, whether to include investments other than cash equivalents, etc).

Adjust for restricted cash in valuation metrics

Investors should note any **restricted cash** and exclude this from net debt or enterprise value calculations, in our view.

Accounting policies such as capitalisation of costs can affect the cash flow presentation. For example, development spending which is capitalised on the balance sheet will be classified as investing cash flows, while development costs which are expensed will be classified as operating cash flows.

Operating profit and cash flow from operating activities not comparable

Finally, analysts sometimes compare operating profit and cash flow from operating activities, but the two figures are not comparable, for example:

- Cash flow from operating activities is after tax and may include interest paid and received, and dividends paid or received, while operating profit is before tax and financial income/expense

- Cash flow from operating activities is before cash flows on capitalised development while operating profit is after the associated amortisation charges
- Cash flow from operating activities is before capex but operating profit is after depreciation costs.

IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors

IAS 8 describes how accounting policies can be changed and what information must be provided, and how errors should be corrected and disclosed.

Main Points of the Standard

Accounting policies should be determined by applying the relevant IFRS. If there is no relevant IFRS, management should use judgement in developing a policy that results in relevant and reliable information for investors. Management should consider the requirements of IFRSs dealing with similar issues, and then consider the guidance in the IASB Framework. Accounting guidance from other standard-setters (eg FASB) may be considered if it does not conflict with IFRSs or the Framework.

Accounting policy changes and corrections of errors usually applied retrospectively; change in estimates applied prospectively

Accounting policies should be applied consistently and only changed if required by an IFRS or if the change will result in reliable and more relevant information. Accounting policy changes are normally applied retrospectively unless the IFRS requires otherwise. Various disclosures are required when an accounting policy is changed, including the nature of the change and the impact on each line item for the current period and each prior period presented.

When a new IFRS has been issued but has not yet been applied by the company, it should disclose this together with information to assess the possible impact will have on the financial statements when applied or a statement that the impact is not known or reasonably estimable.

Changes in accounting estimates, such as a reassessment of the useful life of a depreciable asset, are applied prospectively. Material errors are corrected by retrospective restatement unless impracticable.

Issues for Investors

Watch out for restatement red flags

Accounting restatements should be considered carefully by investors. Many investors consider restatements, whether due to errors or a change in accounting policy, to be a possible “red flag”. Does the restatement give a new impression of previous years’ results, and will future years’ profits be higher as a result of the restatement?

Accounting errors are relatively rare. Errors may suggest weaknesses in financial reporting and controls.

If a company will be affected in future by a new IFRS, it is worth checking the notes for the company’s view on the potential impact, although unfortunately these are usually unhelpful “boilerplate” disclosures.

IAS 10: Events after the Reporting Period

Treatment of events after balance sheet date but before accounts issued

IAS 10 covers the treatment of events which occur after the balance sheet date but before the financial statements are signed.

Main Points of the Standard

Events after the reporting period are those that occur between the balance sheet date and the date when the financial statements are authorised for issue. These events are either **adjusting events**, which affect the amounts in the financial statements, or **non-adjusting events**, which do not affect the amounts in the financial statements but which should be disclosed.

Adjusting events are those that provide new information about the assets or liabilities at the balance sheet date. Examples include:

- Bankruptcy of a customer (indicating a trade receivable impairment existed at year end)
- Determination of profit-sharing or bonus amounts
- Settlement of a court case
- Sale of inventories indicating impairment at year end.

Acquisitions, restructuring, disposals, etc, must be disclosed

Non-adjusting events must be disclosed, together with an estimate of the financial effect (or a statement that an estimate cannot be made). Examples include:

- Acquisitions
- Major restructurings
- Plans to discontinue a business
- Significant changes in tax laws
- Entering into significant commitments.

Issues for Investors

In practice most major non-adjusting post-balance sheet events (such as acquisitions) will already have been announced in accordance with listing rules, or will already be known to the market (eg tax law changes).

IAS 11: Construction Contracts

This is one of two standards covering revenue recognition (the other is IAS 18). IAS 11 describes "percentage of completion" accounting for construction contracts. These two standards are likely to be replaced by a new revenue accounting standard in future.

Main Points of the Standard

Stage of completion accounting for construction contracts

A construction contract is one "specifically negotiated" for the construction of an asset. When the outcome of the contract can be estimated reliably, revenues and costs are recognised by reference to the stage of completion. If a contract is expected to be loss-making, the expected loss must be recognised immediately.

Stage of completion may be assessed by:

- Proportion of costs incurred (most common method in our experience)
- Physical proportion of work completed

Contract revenue is the initial amount agreed in the contract, together with any probable variations or incentive payments. Contract costs include costs that relate directly to the contract or are chargeable to the customer, and allocated general contract related costs (eg insurance, overheads).

Example: A contract is expected to incur total costs of 80 and revenues of 100. In the first year, costs of 32 (ie 40% of total contract costs) have been incurred. It also received a payment of 50 from the customer. The company reports revenues of 40, costs of 32 and profit of 8 on the contract. The balance sheet shows a contract liability of 10.

IFRIC 15 (*Agreements for the Construction of Real Estate*), effective in the EU from 2010, provides guidance about when IAS 11 or IAS 18 applies. IFRIC 15 specifies that IAS 11 applies if the customer is able to specify major structural elements or the design or make major structural changes (whereas most "off plan" purchases involve buying a standard product). IFRIC 15 refers to real estate construction but may be applied in other industries by analogy.[16]

The accounting for construction of public-to-private service concession arrangements is covered by specific guidance in **IFRIC 12 (*Service Concession Arrangements)***. For example, a company builds a toll road in exchange for either a payment from the grantor (eg government) to operate it or the right to charge road users a toll. There are two models within IFRIC 12: when the company is paid directly by the grantor the **financial asset model** is applied (designed to account for the financing provided by the company implicit in the contract). When the company charges end customers the **intangible asset model** is used.

The intangible asset model is somewhat unusual in that total revenue recognised exceeds total cash received. While it is not unusual for cash flow profiles to differ significantly from revenue profiles, it is unusual that at the end of a contract total revenue exceeds total cash receipts. The intangible asset model permits companies to recognise revenue and profit on the construction phase of a contract based on an estimated profit margin, with an intangible asset accrued on balance sheet (representing the right to charge end users). During the operational phase the company then recognises revenue for the services provided, and amortises the

[16] For example, see our report *Vestas Wind System - Brought to Account...*, dated 30 November 2010, for discussion of the application of IFRIC 15.

intangible asset. The net profit from the contract equals net cash flow on completion, but the revenue and EBITDA figures are notably higher than under other accounting models.

Issues for Investors

Greater reliance on accounting estimates = higher risk for investors

Percentage of completion accounting means that companies can report significant revenues and profits on contracts before the final outcome is known. This can sometimes lead to large profit warnings occurring towards the end of contracts. IAS 11 accounting is particularly dependent on management estimates so investors should look at a company's track record in estimating the outcome of contracts accurately. The timing of cash flows may also differ markedly from reported revenues.

Watch out for new revenue accounting standard

The IASB is working on a new IFRS on revenue recognition which will replace IAS 11 and IAS 18 (see page 7). However, we expect that the new standard will continue to allow revenue to be recognised over time on long-term contracts, ie percentage of completion or something similar will still be permitted.

IFRIC 12 which covers certain service concession arrangements can result in somewhat counter-intuitive outcomes (ie revenues exceeding cash receipts if the intangible asset model applies). Investors should be aware of the non-cash nature of some revenue and EBITDA if the IFRIC 12 intangible asset model applies.

IAS 12: Income Taxes

IAS 12 covers accounting for both current and deferred taxes.

Main Points of the Standard

IAS 12 covers current and deferred taxes on income

IAS 12 covers income taxes payable on taxable profits and taxes on distributions to the reporting entity (eg withholding taxes on dividends). This means it does not cover other taxes such as sales taxes, employer taxes on employee salaries or bonus pool taxes.

Current tax is the amount of income taxes payable or recoverable on the taxable profit or loss for a period. Deferred tax is the tax payable or recoverable in future periods in respect of temporary differences, tax losses or tax credits.

Temporary differences are differences between the balance sheet amount of an asset or liability and its tax base (the value attributed to it for tax purposes). Temporary differences can be taxable (implying higher current tax in future) or deductible (implying lower current tax in future).

Example: Suppose a machine was purchased for 1,000 with an accelerated tax allowance available, so it would be depreciated for tax purposes over 2 years, but for accounting purposes it is depreciated over 5 years (both straight line). After one year, the tax base would be 500 but the net book value would be 800. This results in a taxable temporary difference of 300. Assuming a tax rate of 30%, the deferred tax liability on the temporary difference would be 90 (300x30%).

Deferred tax liabilities are recognised for all taxable temporary differences. Deferred tax assets are only recognised on deductible temporary differences, tax losses and tax credits, if it is probable that taxable profits will be available against which they can be offset. Note that the existence of unused tax losses is “strong evidence” that future taxable profits may not be available. Companies are required to disclose information about tax losses, temporary differences and tax credits for which no deferred asset has been recognised.

Deferred tax assets and liabilities are measured at the tax rates expected to apply when they are realised/settled, based on tax laws “enacted or substantively enacted” by the balance sheet date. Deferred tax assets and liabilities are not discounted to present value.

IAS 12 prescribes disclosures intended to help investors understand the tax position, such as a numerical reconciliation between the tax expense and the profit before tax multiplied by the tax rate.

Issues for Investors

Deferred tax can be considered an application of the matching principle

Deferred tax is a poorly understood subject amongst investors. Simplistically, it can be considered as an application of the matching principle – current tax can vary substantially from normal tax rates due to use of tax losses, investments, etc, but deferred tax smoothes out many of these timing differences.

We recommend reviewing the major categories of deferred tax assets and liabilities and considering the implications for future cash flows. For example:

- Deferred tax liabilities relating to fixed assets may crystallise if tax rules change or the company invests less in future

- Tax losses may imply low cash tax rates in future as losses are utilised, but the impact may depend on jurisdictions and expiry of loss carry-forwards
- Deferred tax assets are not discounted so the economic value may be less than the reported amounts
- Pension deficits should be included in valuations net of any associated deferred tax assets (in many jurisdictions corporate pension contributions are tax deductible when paid)

In addition companies may have “off balance sheet deferred tax assets”, eg if it is uncertain whether tax losses can be utilised. These unrecognised potential deferred tax assets may have some value.

It is important to distinguish between tax losses or temporary differences and the resulting deferred tax assets. For example a tax loss of 100 gives rise to a deferred tax asset of 30 (at a 30% tax rate).

For a more detailed review of tax issues and tax accounting, and the implications for investors, please see our report *Taxing Times - An Investors’ Guide to Corporate Tax*, published 16 December 2011, and the subsequent update *Taxing Times Update - Identifying Corporate Tax Winners and Losers*, published 11 December 2012.

IAS 16: Property, Plant and Equipment

IAS 16 covers accounting for fixed assets, such as depreciation methods.

Main Points of the Standard

Cost model or revaluation model

Tangible fixed assets are measured initially at cost. Subsequently they can be measured using a cost model (cost less depreciation and any impairment) or a revaluation model.

Revaluation gains in OCI, losses in P&L

If the revaluation model is applied, revaluations must be carried out "with sufficient regularity to ensure that the carrying amount does not differ materially" from fair value. If one item of property plant and equipment (PP&E) is revalued, the whole class of such assets must be revalued. Decreases in valuation are recognised in P&L (unless they reverse a previous increase recognised in OCI) while increases in valuation are recorded in Other Comprehensive Income (unless they reverse a previous decrease recognised in P&L).

Cost, less residual value, should be depreciated on a systematic basis over the useful life. The depreciation method, which can be straight line, diminishing balance, or another method, should reflect the pattern in which the asset's economic benefits are expected to be consumed.

Depreciation of an asset begins when it is "available for use", ie "when it is in the location and condition necessary for it to be capable of operating in the manner intended by management".

Issues for Investors

Revaluation model is fairly rare

In practice, the revaluation model is fairly rare for property, plant and equipment. Most companies use the cost model. There is no requirement to disclose fair values of fixed assets, although this would be useful.

Straight line deprecation is usual

Straight line depreciation is far more common than other depreciation methods. Unfortunately it can be difficult to check if companies within a sector are using comparable depreciation periods, because the useful lives are often disclosed as broad ranges.

There may be a delay between capitalisation of an asset and the company commencing depreciation of it, if it is not yet "available for use". This can distort calculations of average useful life of a class of assets based on the amounts disclosed in the financial statements. Similarly, some assets may be fully depreciated.

IAS 17: Leases

IAS 17 covers the accounting for both lessees and lessors. Leases are classified into finance leases (on the lessee's balance sheet) and operating leases (off balance sheet). The IASB is planning to issue a new IFRS on leases in future.

Main Points of the Standard

A lease is "an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time". Some arrangements, such as take-or-pay contracts (eg a customer agrees to purchase substantially all of the output of a particular plant), may not take the legal form of a lease but still fall within the scope of IAS 17[17].

Finance lease transfers risks and rewards of ownership

A **finance lease** is a lease that transfers "substantially all" the risks and rewards of ownership. Likely indicators include:

- Ownership transferring at the end of the lease, or an option to buy the asset for much less than market price at the end of the lease
- Lease term being the major part (typically interpreted as 75%+) of the economic life of the asset
- Present value of minimum lease payments being substantially all (eg 90%+) of the fair value of the asset

At the start of the lease, the lessee reports an equal asset and liability, which are measured as the lower of the fair value of the asset and the present value of the minimum lease payments. The asset is depreciated over the shorter of the lease term and the life of the asset (if the asset will not be acquired at the end of the lease). The lessee also reports an interest charge on the lease liability.

Operating leases are off-balance sheet and cost is spread evenly over lease term

An **operating lease** is any lease which is not a finance lease. The lease payments are charged as an expense over the lease term, usually on a straight line basis.

IAS 17 also covers the accounting for lessors, which is largely symmetric with the lessee accounting. If the lessor grants on operating lease, the asset remains on the lessor's balance sheet. The income from the operating lease is usually recorded on a straight line basis.

Lessors that have granted finance leases have transferred the risks and rewards of ownership. Therefore the asset is no longer on the lessor's balance sheet, but it reports a receivable equal to the net investment in the lease. The financial income from the lease is allocated on a systematic basis reflecting a constant periodic return on the net investment in the lease.

Issues for Investors

IAS 17 has been criticised because two similar leases may be treated very differently depending on the operating/finance lease classification. This affects key metrics such as net debt, gearing, operating profit and enterprise value multiples. In addition, comparisons between companies which buy assets and those which lease them can be distorted. In some sectors (eg retail) analysts routinely produce "lease-adjusted" metrics such as EV/EBITDAR, with leases capitalised in the enterprise value. However, current estimates of operating lease liabilities may be imprecise due to the limited information currently available.

[17] Guidance is provided in IFRIC 4, *Determining whether an arrangement contains a lease*.

The IFRIC 4 Interpretation means that some take-or-pay contracts or similar arrangements (for example, in the industrial gases sector) are treated as leases.

Forthcoming IFRS to bring all leases on balance sheet

The IASB's Exposure Draft on leases (see page 9) proposes abolishing the distinction between operating and finance leases (at least for lessee accounting) and bringing all leases on lessees' balance sheets.

IAS 18: Revenue

IAS 18 covers revenue accounting, except for construction contracts covered by IAS 11. The IASB plans to replace IAS 18 and IAS 11 in a comprehensive new standard on revenue (expected publication in 2013).

Main Points of the Standard

Guidance on revenue from sale of goods

Revenue is recognised from the sale of goods when:

- The significant risks and rewards of ownership have been transferred
- The seller no longer has effective control over or involvement with the goods
- Revenue can be measured reliably
- The economic benefits are probable, and
- Costs can be measured reliably

In many cases this is straightforward, eg when the customer takes delivery of the goods, but some situations can be more complicated (eg goods delivered but still subject to conditions).

Revenue for services can be on "stage of completion"

Revenue is recognised for services provided on a "stage of completion" basis (as in IAS 11 for construction contracts) if the revenue, costs and stage of completion can be measured reliably, and if the economic benefits are probable.

IAS 18 contains some illustrative examples for more difficult situations (eg whether revenue should be recognised for goods shipped subject to conditions). However it contains relatively little detailed guidance. For example, there is very little guidance on sales containing multiple elements, such as the sale of a good combined with ongoing service.

Issues for Investors

No detailed industry-specific guidance (unlike US GAAP)

IAS 18 is a general principles-based standard and, unlike US GAAP, does not contain detailed industry-specific revenue recognition rules. The lack of detailed guidance means more reliance on management judgment, and so companies may account for similar transactions in dissimilar ways. Some companies apply more specific US GAAP guidance to the extent it is consistent with IAS 18 principles (for example, in the tech or telecoms sectors).

Unfortunately for investors, it is very hard to assess if companies are applying reasonable revenue policies or what the impact would be if they changed policy, from the information published in annual reports.

More focus on revenue recognition as new standard gets closer

The IASB is expected to publish a new revenue IFRS in 2013 (see page 7) and although this will not be mandatory until 2015 at the earliest, it may increase investor scrutiny of industries with less transparent revenue recognition (eg long-term contract accounting, bundled sales of goods and services, etc). We have discussed revenue recognition relating to specific industries in several recent reports[18].

[18] For example, *Changes to Telecoms Revenue Accounting*, dated 4 April 2012; *Accounting for Global Aerospace & Defence*, dated 10 August 2012, and (relating to the technology sector), *A new accounting controversy*, dated 26 November 2012.

IAS 19: Employee Benefits

Key standard for investors due to valuation impact, complexity, and sensitivity to assumptions

For investors, IAS 19 is important for specifying the accounting for defined benefit pensions and other post-employment benefits. We receive many questions about IAS 19 due to its complexity, the relevance of pensions to many companies' valuations, and the sensitivity of deficits to key assumptions. A revised version of IAS 19 takes effect from 2013.

Main Points of the Standard

We summarise below the current version of IAS 19 (effective from 2013) but also compare it with the previous version of IAS 19, as companies will be affected by the transition during 2013. The updated IAS 19 is mandatory for annual periods beginning on or after 1 January 2013, and we would expect companies (with December year-ends) to apply it from Q1 2013.

Pension liabilities discounted using AA corporate bond yield

Pension liabilities are measured as the estimated future cash flows discounted at a high quality (AA) corporate bond discount rate of appropriate currency and duration. Pension assets are measured at fair value.

Pension deficit must now be on balance sheet

The difference between the pension liabilities and pension assets, ie the pension deficit or surplus, is shown on the balance sheet[19]. The previous version of IAS 19 (no longer permitted from 2013) allowed an alternative method (corridor method) which resulted in some off-balance sheet deficit or surplus. This corridor method specified that actuarial gains or losses each period could remain off-balance sheet if less than the "corridor" of 10% of the greater of pension assets and liabilities. Any gains or losses in excess of the corridor were recognised on the balance sheet, through the P&L, over many years. As a result, the corridor method resulted in meaningless pension assets or liabilities on the balance sheet.

When the current version of IAS 19 first takes effect, companies which previously applied the corridor rule will have to restate the prior year balance sheet to reflect the pension deficit/surplus, as the new rule applies retrospectively.

P&L charge components

From 2013, the main components of the P&L charge are:

- Current service cost (ie the value of the pension benefits earned in the year)
- Net interest expense/income on the pension deficit/surplus

In some cases, other charges may arise from changes to the pension such as settlements or curtailments.

According to the previous version of IAS 19, the P&L cost reflected the management's expected return on the pension assets, offset by an interest charge on the pension liabilities. However, the new IAS 19 requires that the net interest expense/income is calculated by multiplying the pension deficit or surplus by the discount rate applied to the pension liabilities.

Actuarial gains and losses (the difference between the P&L charge and the full mark-to-market movement in the balance sheet) are booked in Other Comprehensive Income.

[19] Note that a pension surplus is only reported on balance sheet if the company will derive an economic benefit from it eg due to refunds or lower future contributions. Additional guidance is provided in IFRIC 14.

Issues for Investors

Revised IAS 19 addresses some weaknesses but problems remain

The revised IAS 19 solves some problems for investors. In particular, the pension deficit will now have to be reported on the balance sheet, so there will no longer be off-balance sheet pension liabilities. In addition, the pension cost in the P&L will be more intuitive than previously, ie there will be an interest charge if the scheme is in deficit and an interest income if the scheme is in surplus.

However, we still see a number of problems with IAS 19 for investors:

- **Inconsistent classification of pension costs**: IAS 19 does not specify where pension costs are reported in the P&L. Some companies report all pension costs within operating profit while others report service cost within operating costs and net pension interest within financial income/expense. Unfortunately, the updated IAS 19 does not address this problem.
- **After-tax deficit unclear**: Although many investors wish to include after-tax deficits in company valuations, IAS 19 does not require disclosure of the net-of-tax pension deficit. IAS 12 requires disclosure of deferred tax assets by major category but nevertheless the tax associated with a pension deficit is not always disclosed. In some cases, there will not be any associated tax asset, so it would not always be appropriate to apply (1-tax rate) to the deficit.
- **Discount rate inconsistently determined**: IAS 19 requires that pension liabilities are discounted using the yield on an index of high quality corporate bond of appropriate duration and currency (high quality has, until now, been deemed to be AA rated). However, we have recently noticed more inconsistency in the discount rates used by different companies. This probably reflects some concerns about the reliability of quoted AA corporate bond yields (for example in the Eurozone) due to a shortage of AA rated long duration corporate bonds.
- **P&L charge inconsistent with actual pension gain or loss in the year**: As actuarial gains or losses will now always be reported in Other Comprehensive Income (and not "recycled" later into the P&L), some economic gains or losses in the pension scheme will never be reported in earnings. Some investors would prefer that the P&L reflects all the company's economic gains or losses.
- **Lack of information about other measures of pension deficit**: The estimate of pension liabilities is highly sensitive to many assumptions (mortality, discount rate, inflation, salary increases, etc). Some investors/analysts may prefer to use or at least consider other measures of the pension liability such as the funding deficit (which determines cash contributions) or buy-out deficit (the valuation which an insurer would apply if considering acquiring the liability). However, these are not required to be disclosed under current rules. Although the revised IAS 19 should improve disclosure to some extent (eg requiring a sensitivity analysis of the impact of actuarial assumptions on pension liabilities), the IASB did not include more specific requirements on expected future cash contributions.

Include net of tax deficit like debt in EV and deduct from DCFs

We recommend including the net-of-tax pension deficit within company valuations, ie including in the enterprise value for EV multiples and deducting from DCF valuations as a debt-like liability. While the IAS 19 measure is certainly not perfect, it is the only consistently disclosed measure of the pension deficit.

If the pension scheme is material to the company's valuation, we recommend checking the IAS 19 disclosures in the annual report, such as:

- Disclosure of pension asset mix – this indicates the risk in the asset portfolio and any hedging of the liabilities
- Key assumptions such as discount rate, inflation and mortality assumptions which affect the liability (discount rate and inflation assumptions should be close to standard benchmarks; mortality assumptions are harder to assess)
- Sensitivity of the liability to changes in discount rate, inflation and mortality assumptions – this allows investors to estimate updated deficits during the year.

IAS 20: Accounting for Government Grants and Disclosure of Government Assistance

This standard permits some government grants to be shown as income in the P&L, whereas others are offset against assets (thus reducing depreciation).

Main Points of the Standard

Government grants are assistance from the government (transfer of cash or other assets) in return for the company complying with certain conditions, such as the company investing in a particular area.

Grant can be liability or reduction in asset on balance sheet

Grants relating to assets may be accounted for in one of two ways:

1. Deducting the grant from the carrying amount of the asset (thus reducing future depreciation)

2. Reporting the grant as deferred income (a liability) and then recognising the income over the useful life of the asset

Grant may be presented as income or reduction of expense in P&L

Other grants should be recognised in P&L systematically to correspond to the related costs (ie those which the grant is intended to compensate). They may be presented in one of two ways:

1. Showing the grant as “other income”

2. Deducting the grant from the related expense

Issues for Investors

We do not receive many questions on this standard. However, it is worth noting the extent to which a company has received government support, particularly if it may not be available in future. Grants may also create significant timing differences between profit and cash flow, and it may not be clear where they have been reported in the cash flow statement.

IAS 21: The Effects of Changes in Foreign Exchange Rates

This standard describes how to incorporate foreign currency transactions and foreign operations into the financial statements.

Main Points of the Standard

IAS 21 applies to accounting for both foreign currency transactions and for translating the results of foreign subsidiaries included in the group accounts.

Reporting foreign currency transactions

Foreign currency transactions are translated into the functional currency as follows:

- Transactions are initially translated at the spot rate (in practice monthly averages may be applied)
- Monetary balance sheet items (eg cash, receivables, debt) are translated at the closing rate
- Other balance sheet items (eg tangible or intangible fixed assets) are translated at the exchange rate applying at the transaction date, ie they are not retranslated
- Exchange gains/losses arising from settlement or translation of monetary items (at different rate from initial recognition) are reported in P&L

Translating foreign subsidiaries

When a subsidiary is translated into the parent's currency for the group accounts, the following steps are applied:

- Assets and liabilities are translated at the balance sheet date closing rate
- The P&L is translated at the exchange rate at the transaction dates (may be approximated by average rate)
- Resulting exchange differences are reported in Other Comprehensive Income

There is additional guidance for translating a subsidiary in a hyperinflationary economy to which IAS 29 applies.

Issues for Investors

Major item in OCI

Exchange differences are often a large item in Other Comprehensive Income, ie balance sheet movements which bypass the P&L. Balance sheets may be volatile due to year-end retranslation of subsidiaries.

Some exposures are hedged

Transactional risk is often hedged (see also IAS 39 for hedge accounting rules) while translational risk may be reduced by matching foreign currency investments and borrowings.

IAS 23: Borrowing Costs

Some interest costs must be capitalised

Borrowing costs associated with the creation of certain assets which take a long time to construct or get ready must be capitalised (prior to 2009, companies had a choice of capitalisation or expensing these costs). This affects interest coverage ratios.

Main Points of the Standard

Interest costs included in cost of assets which take a long time for the company to construct

Borrowing costs (ie interest) associated with constructing or producing any asset that "takes a substantial period of time to get ready for its intended use or sale" must be capitalised.

The costs to be capitalised are either the actual costs on borrowing directly attributable to the asset, or the company's average borrowing cost rate multiplied by the expenditure on the asset (not to exceed the actual borrowing cost incurred).

Borrowing costs start to be capitalised when the company has started activities relating to the asset, has incurred costs related to the asset, and has incurred borrowing costs. Borrowing costs are no longer capitalised once the asset is ready for intended use or sale. Capitalisation should also be suspended if active development of the asset is suspended for extended periods.

Issues for Investors

The intention of this standard is to make internally produced or constructed asset values more comparable with that of purchased assets. For example, if a newly constructed asset is purchased, the purchase price will implicitly reflect the financing costs of the developer. Capitalised interest costs are eventually charged to the P&L (usually in the form of higher depreciation) and this can be seen as matching the income arising from use of the asset.

Need to adjust interest coverage ratios

However, the disadvantage for investors is that the P&L interest costs understate the cash interest costs. This affects interest coverage ratios; P&L interest charges should be adjusted to reflect capitalised interest costs. This is particularly important if a company is financially stretched.

In addition some judgement may be required about when (or how much) borrowing costs should be capitalised, and so companies' accounting practices on capitalisation may differ.

IAS 24: Related Party Disclosures

IAS 24 requires related party transactions to be disclosed. It is a disclosure-only standard, ie it does not affect the accounting for these transactions.

Main Points of the Standard

Dealings with related parties should be disclosed

Related parties may be people (eg shareholders with control, joint control or significant influence over the company, or key management personnel, or close family members of a related party), or companies/other entities (eg other members of the group, associates, joint ventures, pension plans of the group, entities controlled by a related party). Note that investments (ie where the company does not have significant influence over the investee) are not related parties. Individuals are not related parties simply due to being a related party to an associate or other related party.

Companies must disclose:

- The entity's parent and the ultimate controlling party
- All related party transactions, including purchases/sales, provisions of guarantees or collateral, leases, transfers, etc
- Key management personnel compensation, in total and by type (salary/bonus, pension, termination benefits, share-based payments)

Issues for Investors

Related party transactions may not be on an arm's-length basis and some transactions could even be detrimental to other shareholders. A company's business may also be affected if a relationship with a related party changes. Related party disclosures should therefore be reviewed for anything unusual or significant. Investors should be particularly careful to scrutinise related party disclosures if there are significant corporate governance concerns.

Other requirements may go further

National legislation or guidelines may go further than the requirements of IAS 24, for example annual report disclosures about management remuneration are typically more extensive.

IAS 27: Consolidated and Separate Financial Statements

When a group invests in another business, it may be treated as a subsidiary, an associate (IAS 28), a joint venture (IAS 31), or an investment (IAS 39/IFRS 9), depending on the level of investment and the nature of the relationship. IAS 27 addresses the first of these. This standard is largely being replaced by IFRS 10 effective from 2014 (in the EU).

Main Points of the Standard

Subsidiary if "control", typically >50% of votes

Consolidated accounts should include all subsidiaries, ie entities which are controlled by the parent. Control is presumed if the parent owns more than half of the voting power (ie 50% plus 1 vote) unless clearly demonstrated otherwise. Control may exist if half or less of the voting power is owned due to:

- Agreements with other investors
- Power over majority of board votes (can be indirect, due to ability to replace board members)
- Power over financial and operating policies eg due to an agreement

Potential voting rights (eg from options or convertible instruments) are also considered relevant if they are currently exercisable/convertible.

Separate guidance on when special purpose entities (SPEs) should be consolidated is provided in Interpretation SIC 12. Generally an SPE is consolidated if the reporting company is exposed to the majority of the risks and rewards of ownership.

Subsidiaries should be included with the same period end as the parent accounts, but at most no more than 3 months different.

If the group sells a stake in a subsidiary while retaining control, or buys out a minority interest, no gain or loss is reported in the P&L (ie the adjustment is within shareholders equity). However if control is lost, a gain or loss is reported.

The standard also covers reporting of subsidiaries in the separate (legal entity) accounts, but equity investors typically focus on group (consolidated) accounts.

Issues for Investors

Consolidation rules are a grey area

Determining whether another business is controlled and should be consolidated can be a grey area in IFRS, and is not consistently applied in practice. When a company is consolidated, its revenues, profits, assets, liabilities and cash flows are fully included in the group accounts, whereas only the net profit, net assets, and dividends from associates are included. Companies may therefore have incentives to consolidate businesses which are high margin or with strong balance sheets or good cash flow, and to exclude from consolidation businesses with poor profitability, high debt or poor cash flow.

We recommend reviewing why material businesses are consolidated if ownership is less than 50% or not consolidated if ownership is over 50%.

Minority interests can be significant to valuation, but unfortunately disclosures are typically minimal (eg no information about fair value or about the minority share of cash flows). We do not recommend valuing minority interests at the balance sheet amount as this is often a significant underestimate of the value.

Some investors also find it counterintuitive that when a group sells a stake in a subsidiary, it does not report a gain or loss, whereas when it purchases a newly controlling stake in an associate, a gain or loss on the associate investment is reported (although the stake has not been sold).

In future IFRS 10 will replace most of IAS 27 together with the guidance on consolidation of special purpose vehicles in SIC 12. IFRS 10 was issued with an effective date of 1 January 2013, but in the EU mandatory adoption has been postponed to 1 January 2014.

IAS 28: Investments in Associates

This standard describes when an investment should be treated as an associate and hence the equity method should be applied.

Main Points of the Standard

Associates if "significant influence", usually 20% of votes

An investment is treated as an associate if the group has significant influence but not control; any investment which is controlled is a subsidiary within the scope of IAS 27. Significant influence is assumed if the holding (voting power) is 20% or more, unless demonstrated otherwise. However, significant influence can exist with less than 20% holding, eg due to board representation. Potential voting rights (options, converts, etc) which are currently exercisable should also be considered. This is similar to the guidance for control in IAS 27 (ie there is a presumption at a certain shareholding but it can be overcome by other factors).

Use equity method ie one-line treatment in P&L and balance sheet

Associates are presented in the group accounts using the equity method. This means that:

- Associates are initially measured at cost, but this is subsequently adjusted for the group's share of comprehensive income (including profit/loss)
- The share of associate profit/loss is reported as a line in the P&L (eg if the shareholding is 25% and the profit after tax of the associate is 100, associate income of 25 will be reported)
- Dividends from the associate are included in the cash flow statement, and reduce the carrying value of the investment

Associate investments may become impaired. Determining *if* the investment is impaired uses the impairment test for equity investments in IAS 39, but the *size* of the impairment is determined in accordance with IAS 36 (ie higher of value in use and fair value less costs to sell).

Issues for Investors

Another grey area

Like IAS 27, determining whether an investment is an associate can be a grey area in IFRS and in practice the guidelines may not be consistently applied. In our experience, associate treatment is quite common at shareholdings well below 20% (sometimes as low as 6%).

Inconsistent with treatment of other equity investments

Associate treatment is different from the accounting for normal equity investments in the scope of IAS 39/IFRS 9. Other equity investments are measured at fair value on the balance sheet. Companies may prefer to treat an investment as an associate, because of the more stable balance sheet valuation. Also, impairment charges are typically much smaller for associates, because a DCF calculation can be used (whereas IAS 39 requires a write down to market value if impaired, although IFRS 9 will not).

Lack of information

IAS 28 requires minimal information about associates (eg fair value disclosed only if there are published prices, no information required about associate cash generation, no information about gross asset/liabilities or debt). In future new disclosure standard IFRS 12 (see page 33) should improve disclosure, including summarised P&L and balance sheet information for each material associate.

Apparent P&L tax rates distorted

Associate income is presented above the tax line of the P&L[20], but is an after-tax figure. This can distort apparent tax rates.

[20] Occasionally we have seen it presented below the tax line, but this is inconsistent with IAS 1 guidance.

IAS 29: Financial Reporting in Hyperinflationary Economies

Historical cost accounting may become somewhat meaningless in hyperinflationary economies unless an adjustment is made for inflation.

Main Points of the Standard

Hyperinflation indicated if inflation of 100%+ over 3 years

Indicators for determining when an economy is in hyperinflation include the population preferring to keep wealth in other assets or currencies, or a cumulative inflation rate over three years of 100% or more (eg 26% pa or more). IAS 29 applies to companies whose functional currency is that of the hyperinflationary economy. IAS 29 is applied from the start of the reporting period in which hyperinflation is identified.

Monetary items on the balance sheet are not restated, but non-monetary items are restated by increasing by the inflation rate (ie change in the price index) from the date the item was acquired. P&L items are restated by applying the inflation rate from the date the income/expense was recorded. Companies suffer a loss on a net monetary asset and a gain if they have a net monetary liability (if these assets/liabilities are not linked to a price level). This gain/loss is reported in the P&L.

Once the economy is no longer hyperinflationary, the restated amounts at the end of the previous reporting period are used as the new carrying amounts for assets/liabilities.

Issues for Investors

Companies may have subsidiaries in hyperinflationary economies. When the decision is made that IAS 29 applies, a significant restatement of balance sheet and earnings may occur.

Venezuela is a relatively recent example of a hyperinflationary economy[21].

[21] For example, Telefónica applied IAS 29 to its Venezuelan business in its 2009 financial statements.

IAS 31: Interests in Joint Ventures

IAS 31 currently provides two possible ways of accounting for many joint ventures. This will be replaced by IFRS 11 from 2014 in the EU.

Main Points of the Standard

A joint venture is an arrangement (often but not necessarily a company or other legal entity) subject to joint control between the reporting group and another party. Joint control means that key strategic decisions require the consent of both controlling parties.

Choice of JV accounting

Companies may use the equity method or proportionate consolidation to report their share in joint venture (JV) entities. The equity method is also used for associates and is described in IAS 28.

Proportionate consolidation means that the group's share of the JV's revenues, costs, profits are included in the P&L, its share of assets and liabilities in the balance sheet, and the relevant proportion of the JV cash flows is included in the cash flow statement.

Issues for Investors

Affects cash flow reporting as well as P&L, balance sheet

The current choice of accounting reduces comparability. A group will report higher revenues and a "grossed-up" balance sheet with proportionate consolidation, while equity accounting may be preferable for JVs with low profitability, poor/negative cash flow and/or significant debt.

Proportionate consolidation may mean reported cash flows are not readily accessible to the group (eg distributions will need to be agreed with the joint venture partner).

IAS 31 will be replaced by IFRS 11, see page 31.

IAS 32: Financial Instruments: Presentation

IAS 32 and IAS 39 both cover financial instruments

This standard should be read together with IAS 39, concerning the recognition and measurement of financial instruments, and IFRS 7, which covers required disclosures about financial instruments.

Main Points of the Standard

Debt/equity definition and treatment of converts

IAS 32 defines when a company's own financing should be classified as debt or equity (eg preference shares, hybrid debt, etc).

Equity financing must not contain any contractual obligation to deliver cash or other financial asset, for example equity instruments must be perpetual and dividends must be discretionary rather than fixed. A contractual obligation to deliver cash or another financial asset is a financial liability (debt).

Convertible debt accounting

Convertible debt is treated as a compound financial instrument and split into debt and equity components (reported as debt and equity on the balance sheet). The debt component is valued by measuring fair value of equivalent debt without the conversion feature and the equity component is the residual (ie value of convertible debt less estimated fair value of debt component).

IAS 32 requires that treasury shares are deducted from equity.

Rules on netting off

IAS 32 also provides guidance on when financial assets and liabilities may be netted off (for example a derivative asset and liability with the same counterparty). They should only be offset when the company has both a legal right to net off, and intends to settle on a net basis.

Issues for Investors

Interest on hybrid debt may not go through P&L

Hybrid debt may qualify for equity classification. This will mean that the interest on the hybrid debt will be classified as dividend payments and so not reported in the P&L (and also classified as dividends rather than interest in the cash flow statement). Investors may wish to adjust interest cover calculations and after-interest free cash flow figures. (Note, however, that EPS calculations will already take hybrid interest payments into account).

Since convertible bonds are split into debt and equity components, P&L interest charges do not reflect the actual cash interest costs but the appropriate interest rate for a similar non-convertible debt, applied to the debt component. P&L interest charges will be higher than cash interest charges.

US/IFRS bank balance sheets not comparable

Offsetting rules differ between US GAAP and IFRS and this reduces the comparability of IFRS and US GAAP bank balance sheets (more netting in US GAAP). IFRS 7 has recently been amended to require additional disclosure about this offsetting.

IAS 33: Earnings per Share

Basic and diluted earnings per share (EPS) must be disclosed, and IAS 33 provides guidance on how to calculate the denominator (number of shares).

Main Points of the Standard

IAS 33 requires companies to calculate two earnings measures, basic EPS and diluted EPS. Diluted EPS takes into account the effect of dilutive potential ordinary shares, eg convertible debt and options.

Basic EPS only reflects shares outstanding

Basic EPS is calculated by dividing the net income attributable to the ordinary shareholders of the parent company (ie after minority interest's share of net income, preference dividends, interest payments on hybrid debt classified as equity, etc) by the time-weighted average number of ordinary shares outstanding in the period. For example, if 100 shares were outstanding at the start of the year and a further 20 shares were issued half way through the year, the basic number of shares is 110. The basic number of shares does not include any shares still subject to vesting conditions.

Diluted EPS reflects potential shares from options or converts

Diluted EPS takes into account the possible effect of potential ordinary shares, such as convertible debt or options. Options are only deemed dilutive when they are "in the money" (market price exceeds exercise price). Options are treated as a combination of shares issued at market price (due to value from the exercise price) which are not dilutive, and shares issued for no consideration. For example, if 10 options exist to buy a share currently trading at £2 for an exercise price of £1, the dilution would be 5 shares.

For convertible debt, the EPS should be calculated as if the convertible converted into shares at the start of the period, with the net of tax interest charge on the convertible added back to net income. If this EPS is lower than EPS without conversion, then the convertible is dilutive and diluted EPS should be calculated assuming its conversion.

Unvested shares that require only future service as a vesting condition are included in calculating diluted EPS. However if there are other vesting conditions which have not yet been met (such as achieving an earnings target), the unvested shares are included in diluted EPS only if they "would be issuable if the end of the period were the end of the contingency [vesting] period". Similarly, unvested employee options are only included in calculating diluted EPS if the options are only subject to a service condition, or if any other conditions have been met by the reporting date.

Both basic and diluted EPS must be restated for the impact of rights or bonus issues. An adjustment factor is calculated to rebase reported pre-rights EPS. The adjustment factor is calculated as the fair value per share cum rights divided by the theoretical ex-rights value per share (TERP). For example, in the case of a company with shares trading at £30 prior to a rights announcement and a TERP of £20, the previously reported EPS would be divided by 1.5 (ie £30/£20), and therefore pre-rights EPS of £3 would be reduced to £2.

Treasury shares (shares repurchased and held by a company) are deducted from equity and are not included in EPS calculations. Shares held in an employee benefit trust are treated like treasury shares if the trust is de facto controlled by the company.

Issues for Investors

EPS and Price/Earnings multiples are widely used by investors so it is important that there is guidance on calculating the number of shares used in EPS calculations. Both basic and diluted EPS should be displayed though some companies emphasise basic EPS and some diluted EPS.

Diluted EPS calculation flawed but preferable to basic EPS

Diluted EPS only includes options to the extent they are "in the money" (intrinsic value) so it understates the full economic impact. Although we think the diluted EPS calculation is flawed, we believe it is a better measure than basic EPS. We favour diluted EPS as we believe it is appropriate to include the potential dilution to ordinary shareholders of other equity claims from option holders and convertible debt holders. We do not agree with the argument that diluted EPS double counts the impact of employee options expensed through the P&L; rather the dual effect on EPS correctly reflects the economic impact of the options.

We also note that IFRS 2 (Share-based Payment) and IAS 33 take different approaches to share-based payment, eg IFRS 2 measures options at fair value, while IAS 33 only captures the intrinsic value of options. We discussed this in *Deferred employee compensation - A primer for equity investors*, dated 7 November 2012.

IAS 33 focuses on the calculation of the denominator not the numerator for earnings per share. EPS figures may not be fully comparable due to different accounting choices in calculating net income. In addition, many companies provide adjusted versions of EPS which are not consistent with IFRS requirements. For further discussion of EPS measures, see *Adjusted Earnings - A Review of Non-GAAP EPS in Europe*, dated 8 November 2010.

IAS 34: Interim Financial Reporting

Limited requirements for interim accounts

This standard explains how quarterly and half-year reports should be prepared and states minimum information which must be provided. The requirements for interim reports are less extensive than for annual reports.

Main Points of the Standard

Interim accounts should include:

- P&L/Statement of Comprehensive Income (may be one or two statements)
- Balance sheet
- Cash flow statement
- Statement of changes in equity
- Certain note disclosures, such as some segment information, unusual items (often called exceptionals), information about M&A, dividends paid, etc. Companies must also disclose any events/transactions which are material to understanding the results.

The statements may be condensed compared to full year accounts, but must contain at least the headings and subtotals. Accounting policies used should be the same as those in the previous annual report, unless there is an accounting policy change to be reflected in the next annual statements (eg due to a new accounting standard taking effect).

IAS 34 was amended with effect from 2011, and now explicitly states that disclosure is required for changes in economic circumstances that affect the fair value of a company's financial instruments, whether carried at amortised cost or fair value, if the effect is significant. Companies must also disclose any impairments or reclassifications of financial assets, and details of transfers between levels of the fair value hierarchy. This disclosure was relevant to financial institutions' holdings of peripheral European sovereign debt during 2011.

Issues for Investors

EU listed companies must apply IAS 34 to half year accounts

EU listed companies have been required to apply IAS 34 when issuing interim results since 2008, although this requirement does not apply to "interim management statements" (IMSs) which are not full results. EU companies must publish half-year results, but IMSs are permitted instead of full quarterly results (some countries go further in requiring quarterly results). The EU considered making quarterly results mandatory but decided against this in the face of considerable opposition from some companies, particularly in the UK, which argued this would encourage "short termism" and would be a considerable administrative burden. A small number of companies have actually stopped issuing quarterly results, perhaps due to the need to apply IAS 34.

The IAS 34 requirements are less onerous than for full year results and this can be frustrating for investors. For example, some companies update pension valuations while others do not, even if pension risks are highly material.

IAS 36: Impairment of Assets

This standard sets out how and when to test assets for impairment. IAS 36 applies to all assets unless covered by the valuation methodology in another standard such as inventory (IAS 2), financial assets (IAS 39), deferred tax assets (IAS 12), pensions (IAS 19).

Main Points of the Standard

Compare book value with higher of fair value and DCF

An asset is impaired if the book value is higher than the recoverable amount. Recoverable amount is the higher of fair value less selling costs and a DCF valuation (known as value in use).

A company must calculate the recoverable amount of an asset if at the end of the reporting period there is any indication of impairment (such as significant decline in asset's market value, adverse changes in the business environment, higher interest rates, or company-specific issues such as restructuring plans). Intangible assets which are not amortised, such as goodwill, must be tested for impairment annually.

Guidance on DCFs

The DCF valuation used to calculate value in use must reflect the expected cash flows from the asset, the time value of money (ie risk-free interest rates), and other factors such as uncertainty of cash flows, the price of risk, and illiquidity (the latter factors may be incorporated by adjusting expected cash flows or the discount rate). Cash flow projections should be based on current budgets/forecasts (normally for a maximum of 5 years). Long run growth rates assumed should normally be steady or declining.

Impairments and reversals usually through P&L; goodwill impairment cannot be reversed

Impairment losses are normally reported in the P&L, unless they reverse a previous revaluation increase not reported in the P&L. After the impairment, any depreciation or amortisation is revised to reflect the lower carrying amount. Impairment charges can be reversed through the P&L, except for goodwill.

Goodwill is allocated to "cash-generating units" (CGUs) which must be no larger than an operating segment, while the standard does allow for significant flexibility in selecting CGUs. Goodwill is tested for impairment at the level of these units. Goodwill impairments cannot be reversed.

Issues for Investors

DCFs subjective

Many investors are somewhat sceptical about the value and rigour of impairment testing, in particular as DCF valuations are so subjective.

Goodwill impairment charges may not occur even if an acquisition is clearly not worth the price originally paid, because the decline in value of the acquired goodwill may be offset by internally generated goodwill in another part of the unit. The size of CGU chosen and later re-allocations of goodwill amongst units (eg due to changes in reporting structure) may also reduce the likelihood of goodwill impairment. Occasionally companies only report one segment/CGU.

Possible incentive to maximise goodwill

Since goodwill (and other intangibles with indefinite life) is no longer amortised, there may be a greater incentive for acquisitive companies to maximise goodwill, eg through fair-value write-downs of acquired assets or recognising additional liabilities such as provisions on acquisition.

May flatter "underlying" earnings

Impairment charges are often treated as exceptional items, but may reduce future expenses such as depreciation or amortisation, so "underlying" earnings may be flattered by impairments. Similarly, impairment charges reduce net book value, so they increase apparent return on equity figures.

IAS 37: Provisions, Contingent Liabilities and Contingent Assets

This standard describes how provisions should be calculated, and requires disclosure of contingent liabilities. Pensions are an important type of provision but are covered separately in IAS 19.

Main Points of the Standard

Uncertain liabilities

A provision is a “liability of uncertain timing or amount”. Provisions should be recognised if the liability (for cash or other outflow) is probable (ie >50% probability).

Provisions are measured at the best estimate of the cost of settling the obligation, which may be a probability-weighted figure (expected value) in some cases, or the most likely outcome in others (although other outcomes must be considered).

The provision should be a present value if discounting has a material effect. The expense as the discounting unwinds over time (increasing the liability) is reported as an interest cost.

Provisions permitted for restructuring if conditions met

Provisions must not be recognised for future operating losses, but they are recognised for onerous contracts (a contract is onerous if the unavoidable costs associated with it are more than its economic benefits). A provision may be made for restructuring, but only if certain criteria are met, including a detailed formal plan for restructuring and announcement of the plan to affected parties or starting to implement it.

Contingent liabilities are disclosed

A contingent liability is a possible but unconfirmed liability, or a present obligation which is not probable to result in cash outflow or other loss, or a present obligation which cannot be measured reliably enough to recognise. Contingent liabilities are not reported as a liability on the balance sheet but must be disclosed. (Contingent assets are disclosed if probable).

Issues for Investors

Can be used to manage earnings

Provisions create differences between cash flow and earnings, and may allow companies to manage earnings. For example, the use of “cookie jar” provisions is a well-known creative accounting technique, although rules on provisions are stricter than in the past. As uncertain liabilities, provisions involve more accounting judgement than many other balance sheet items. Provisions may also be used to “kitchen sink” bad results and improve subsequent earnings.

For this reason investors are often sceptical of companies which record large provisions. IAS 37 requires the disclosure of a reconciliation of opening and closing provisions, and so any provision releases (creating earnings without cash inflow) or utilisation of provisions (cash outflow with no P&L impact) can be identified. We recommend checking the provision note[22]. Provisions created at acquisition which increase goodwill are not charged to the P&L but may flatter subsequent earnings relative to cash flow.

Provisions for long-term liabilities, such as some environmental liabilities, for which the cash outflows are not captured in a DCF model, should be treated like debt in valuations.

Contingent liabilities can be highly material, eg potential legal liabilities, so this note should be scrutinised, although disclosure is often limited or “boilerplate”.

[22] See *The Standards: Annual Report Review*, dated 16 May 2012, for more details.

IAS 38: Intangible Assets

Some intangible assets are recognised in the accounts, but many internally generated intangible assets are not. In particular, IAS 38 explains when development costs should be capitalised and when expensed, which we are frequently asked by investors.

Main Points of the Standard

Intangible assets are non-monetary assets without physical substance. They may be acquired through M&A, separate purchase, or may be internally generated.

Criteria for capitalisation

To capitalise an intangible asset on balance sheet it must meet these criteria:

1. Identifiable – either separable (eg capable of being separately sold) or arising from contractual/legal rights
2. Probable benefit from asset
3. Measurable cost

Intangible assets which are separately purchased or internally generated are recognised initially at cost. Assets acquired by M&A are measured initially at fair value. Most intangible assets are subsequently measured at amortised cost, although IAS 38 permits revaluation if there is an active market for the asset. If the asset has an indefinite life (eg goodwill) it is not amortised.

Internal research costs are expensed. Developments costs are capitalised if they meet criteria such as technical feasibility of project, probable economic benefits, intention to complete the asset, and reliable measurement of costs.

Issues for Investors

Amortisation charges often added back in adjusted earnings

As a result of IAS 38, many more acquired intangible assets (value of customer relationships, customer lists, etc) are recognised separately from goodwill, and are amortised. There is some controversy as to whether these amortisation charges are meaningful, and many companies, analysts and investors add back amortisation charges in adjusted earnings measures. In our view, some amortisation charges should not be added back[23].

May need to adjust for R&D capitalisation policy

The rules on capitalising internal development costs are perceived by many investors as rather vague and inconsistently applied. In practice, the extent of capitalisation varies greatly between sectors, eg pharmaceutical companies do not capitalise development costs due to the uncertainty of regulatory approval. Company results within sectors may also be less comparable because of differing capitalisation policies, for example in the aerospace & defence sector[24]. This can affect several key metrics such as EV/EBITDA, P/E, Price/book, and ROE.

[23] See *Adjusted Earnings* report previously mentioned for detailed discussion.

[24] See *Accounting for Global Aerospace & Defence*, dated 10 August 2012.

IAS 39: Financial Instruments: Recognition and Measurement

Much criticised in the credit crisis, IAS 39 will (eventually) be replaced by IFRS 9 (see pages 10 and 28). It should also be considered together with IAS 32 (financial instrument presentation) and IFRS 7 (financial instrument disclosures).

Main Points of the Standard

We summarise below four main aspects of IAS 39: the treatment of financial assets, financial liabilities, specific rules for derivatives, and the calculation of impairments of financial assets.

4 categories of assets

Financial assets (investments) are classified into four categories as shown in Figure 7. Note that IAS 39 does not apply to associates, JVs or subsidiaries.

Figure 7. IAS 39 Classification of Financial Assets

Category	Includes	Accounting
FV through P&L	All derivatives, trading book assets	Marked to market through P&L
Available for Sale	Default category eg equities not held for short term trading, most quoted debt	FV on balance sheet. Dividends/interest, realised gains/losses in P&L
Loans & receivables	Debt instruments not quoted in active market	Amortised cost
Held to maturity	Debt instruments held to maturity	Amortised cost

Source: IASB, Citi Research

This means that a quoted bond, for example, may be measured in one of three ways depending on the company's intentions: either at fair value through P&L (if the bond is held for trading in the short term), Available for Sale (in most other cases), or amortised cost (if the bond will be held to maturity). Available for Sale (AFS) is a hybrid of fair value and amortised cost accounting: these assets are measured at fair value on the balance sheet, but the P&L accounting is similar to amortised cost assets, except for the impairment calculation. Equities may be classified either at fair value through P&L or AFS.

Assets may be reclassified between categories in certain circumstances[25].

The effective interest rate (EIR) method is applied to financial assets and liabilities held at amortised cost. The EIR is the interest rate which exactly discounts the estimated cash payments and receipts of the instrument to the initial carrying amount of the instrument. It is used to determine the appropriate interest income/expense to be recognised in each period and the amortised cost carrying value at each period end.

Liabilities at amortised cost or FV through P&L

Financial liabilities are measured at amortised cost or fair value through P&L. Fair value applies if the liabilities are held for trading, derivatives, or if the company elects fair value treatment. All other liabilities are at amortised cost.

Derivatives at FV on balance sheet; hedge accounting may apply

All **derivatives** are measured at fair value on the balance sheet, and in most cases the change in value is reported in the P&L. However, specific rules apply to derivatives held for **hedging** purposes. Gains/losses on derivatives qualifying as cash flow hedges are usually not recognised in the P&L until the underlying cash flow is realised. Derivatives held as fair value hedges are marked-to-market through

[25] The IASB amended IAS 39 in October 2008 to allow certain reclassifications; many European banks took advantage of this amendment and reclassified assets out of the fair value and AFS categories. Some also reclassified sovereign debt holdings in 2010/2011.

the P&L, but so is the hedged instrument. Quite onerous rules apply before hedge accounting can be applied, eg the hedge must be shown to be effective.

Impairment tests for AFS and amortised cost

Financial assets which are not measured at fair value through P&L are tested for **impairment**. Assets are impaired if there is objective evidence that a "loss event" has occurred which has an impact on the future cash flows. Such evidence includes significant financial difficulty of the issuer and breach of contract (eg default/delinquency in payments) but may also include economic factors which correlate with defaults (eg higher unemployment rates). Additional guidance is provided to determine when AFS equities are impaired (for example an equity is impaired if there is a "significant" or "prolonged" decline in the market price).

If amortised cost instruments are impaired, they are written down to the present value of the estimated cash flows, discounted at the original effective interest rate (with the impairment charged to P&L). If AFS assets are impaired, they are written down to fair value through the P&L.

Issues for Investors

The choice of accounting methods for financial instruments reduces comparability of banks' (and to some extent insurers') balance sheets and P&Ls.

Controversial amendment in 2008

The IASB's amendment of IAS 39 in October 2008 to allow reclassifications between asset categories was widely criticised by investors. The amendment, made as a result of political pressure at the height of the credit crisis, allowed banks to transfer assets out of fair value and AFS categories, and thus increase book values or avoid P&L write-downs. A majority of large EU listed banks made such reclassifications at the time. Some banks also reclassified peripheral European sovereign debt in 2010/11.

The fair value treatment of some financial liabilities has been controversial, as it may result in counterintuitive P&L gains when the credit standing of a company's own debt deteriorates.

Impairment rules criticised as backward looking

Impairment rules are open to interpretation and are not consistently applied. In addition, the "incurred loss" impairment rule in IAS 39 has been criticised as too backward-looking and therefore not providing timely information about loan impairments.

Hedge accounting rules are complicated and therefore some companies do not apply hedge accounting to their hedging. The resulting P&L volatility is sometimes excluded from "underlying" earnings calculations.

IAS 39 will be replaced in future by IFRS 9, discussed on page 28.

IAS 40: Investment Property

There are different accounting rules for investment properties compared to other properties (which are covered by IAS 16). Investment properties may be measured at fair value or at (depreciated) cost.

Main Points of the Standard

Investment properties are those held to earn rentals or for capital appreciation. Owner-occupied properties do not qualify as investment properties. The standard applies to all investment properties, whether held by a property company or not.

Choice of measurement, but must be applied consistently

Investment properties may be measured at fair value or at (depreciated) cost. The same policy must be applied for all investment properties. If measured at fair value, changes in value are reported in P&L. If measured using the cost model, IAS 16 requirements apply. If measured at cost, the fair value should be disclosed unless (in exceptional cases) it cannot be determined.

Fair value can be based on DCF if market price not available

The best evidence for fair value is current prices in an active market for similar properties, but other indicators of fair value can be considered such as current prices of different properties, recent prices of properties in less active markets, and DCF valuations based on expected cash flows. Companies are not required to use an independent or professionally qualified valuer; however, they should disclose if the valuation has been made by an independent professional valuer with relevant experience or not. They should also disclose the methods and assumptions used in valuation.

Issues for Investors

Balance sheet should be reasonable guide to market value

The fair value model is used by most European property companies. The use of fair values means that the balance sheet is generally a reasonable guide to valuation and price/net asset value is a widely used valuation metric in the property sector.

IAS 40 gives a choice of accounting method so some companies may use depreciated cost, which would reduce comparability. Note that US GAAP does not have an equivalent standard so the historical cost model is used for most real estate companies or other companies holding investment-type property.

IAS 40 does not require a company to use an independent or professional valuer (although this should be disclosed) and the standard permits a variety of valuation methodologies, so investors should check the relevant disclosures.

IAS 41: Agriculture

This is a niche standard covering the treatment of biological assets (eg trees in a plantation forest, vines, cattle, etc), which should be measured at fair value. However, many investors have concerns about the reliability of these valuations.

Main Points of the Standard

Biological assets measured at fair value less costs to sell with gains/losses recognised in P&L

Biological assets (living animals or plants) and agricultural produce at the point of harvest are covered by this standard. After harvest, IAS 2 (Inventories) will apply.

These assets should be measured at fair value less costs to sell. If fair value cannot be measured reliably, they are measured at cost, but there is a presumption that fair value can be measured reliably. Fair value is based on active market prices where available, but can also be based on recent transaction prices, industry benchmarks or the NPV of the expected cash flows of the assets using a market based discount rate. Fair value is remeasured at each reporting date with gains and losses reported in P&L.

IAS 41 also covers the treatment of related government grants. For grants relating to assets measured at fair value less costs to sell, the rules differ to those for grants related to assets held at cost (where IAS 20 applies, see page 52). Unconditional grants are recognised in P&L when they become receivable and conditional grants when the grant conditions are met.

IAS 41 requires disclosure of the nature of activities involving biological assets and a reconciliation of the movement in the value of biological assets, including fair value gains and losses, and increases and decreases caused by purchases, sales, and transfers to inventory on harvest.

Issues for Investors

This is only relevant to the relatively small number of listed companies which produce biological assets as part of their business, although the number affected has increased as IFRS or equivalent standards have been adopted in more countries globally.

Example of trend towards fair value accounting

IAS 41 illustrates the significant use of fair value measurement rather than cost in IFRS. Fair value measurement generally results in more relevant (though sometimes less reliable) asset values on the balance sheet, but is criticised by some for creating more volatile and/or less meaningful earnings.

Biological asset valuations can be very subjective (eg DCF)

IAS 41 permits earlier recognition of profits from cultivation of biological assets, compared to the profit recognition pattern under cost accounting. While theoretically preferable, P&L gains based on the fair value of growing biological assets can be very subjective, particularly in the case of assets where no active market exists or where there is a long growth period (eg a plantation of trees). Furthermore, agricultural prices can be volatile and cyclical, meaning that earnings may be volatile.

Many investors have concerns, particularly following Sino-Forest case

Biological asset accounting in IFRS is quite controversial with many investors concerned about the reliability of these fair value gains. For example, Sino-Forest Corp’s shares fell sharply following publication of research questioning the valuation of its assets, and the company subsequently filed for bankruptcy protection in Canada. More recently, a short seller queried Olam International’s fair value gains

on biological assets[26]. In US GAAP, biological assets are generally measured at historical cost (lower of cost and fair value).

The IASB is currently working on a limited scope project on IAS 41, which will consider whether mature bearer biological assets (eg vines, fruit trees, rubber trees, livestock from which milk is produced, etc) should be accounted for in accordance with IAS 16 rather than IAS 41 (eg depreciated like property, plant and equipment, rather than measured at fair value). This may result in an Exposure Draft in 2013, with revisions potentially effective from 2015.

[26] See *The Standards: December Update*, dated 5 December 2012, for more details.

Appendix 1: US GAAP & IFRS comparison

We have compiled a list of the differences in accounting rules between IFRS and US GAAP which are significant for investors. This is not therefore an exhaustive list, and we are happy to provide more detail in specific areas on request.

Figure 8. US GAAP and IFRS comparison part 1

Topic	Sub-topic	Difference
Revenue	General	US GAAP rules based with some sector specific rules while IFRS is more principles based. The IASB and FASB are currently working on a joint project to revise and converge revenue recognition rules.
	Contingent revenue	Contingent revenue is recognised under IFRS when receipt is probable. US GAAP does not permit contingent revenue recognition until the contingency is resolved.
	Loyalty schemes	IFRS requires the fair value of loyalty credits to be held as deferred revenue and recognised when the credits are used by the customer. US GAAP permits use of this model but also allows the cost of fulfilling loyalty credits to be accrued as an expense.
	Service contracts	US GAAP prohibits use of the cost based percentage of completion method for most service contracts, allowing either the recognition when the contract is complete or based on the proportion of total contract services provided. IFRS permits use of the cost based method.
	Construction contracts	When the outcome of a long term construction contact cannot be estimated reliably IFRS requires recognition of revenues to the extent costs are expected to be recoverable with no profit recognition. US GAAP requires use of the completed contract method (no revenue or expense recognised until contract completion) in this circumstance unless there is an assurance of no loss on the contract (eg cost plus billing) in which case the treatment is equivalent to IFRS. Expected contract losses are recognised immediately under IFRS and US GAAP.
Expenses	Borrowing costs	US GAAP permits capitalisation of borrowing costs incurred within an investment accounted for using the equity method (eg a JV).
	Advertising costs	US GAAP permits capitalisation of certain direct response advertising costs while IFRS prohibits capitalisation of any advertising costs.
Non-financial assets	Inventories	US GAAP permits use of the last-in, first-out (LIFO) method of inventory valuation, whereas IFRS does not. IFRS requires use of the same valuation method for all similar inventories (eg FIFO, weighted average cost) but US GAAP does not.
	Intangible assets	IFRS permits revaluation of intangible assets (if determined by reference to active market). US GAAP does not.
	Impairment of goodwill	The detail of goodwill impairment tests vary between US GAAP and IFRS; US GAAP requires comparison of the carrying amount with fair value of the unit, while IFRS requires the carrying amount to be compared with the recoverable amount (which is the higher of a DCF value in use and the fair value less costs to sell). Under US GAAP goodwill impairment tests impair only goodwill while under IFRS if the impairment test determines impairment in excess of the value of goodwill other assets may also be written down.
	Impairment reversals	IFRS permits impairment reversals for non-financial assets (excluding goodwill) and US GAAP does not.
	Development costs	US GAAP does not permit capitalisation of development costs aside from in the case of software development for sale to third parties. IFRS requires capitalisation of development costs if criteria are met.
	Property, plant & equipment (PPE)	IFRS requires depreciation of each aspect of PPE separately if it is significant in relation to the total cost of the item. US GAAP depreciates assets over a useful life attributed to the asset as a whole.
	PPE revaluation	IFRS permits revaluation of tangible assets. US GAAP does not.
	Investment properties	No equivalent to investment property accounting (fair value through P&L) in US GAAP where the cost method applies (except for investment companies which measure assets at fair value).
	Leases	Lease classification (finance vs operating) rules vary; under US GAAP a lease is financing when the present value of minimum lease payments exceeds 90% of the value of the asset. IFRS has no quantitative break points and a lease is financing when substantially all of the risks and rewards of the asset are transferred through the lease.
Non-financial liabilities	Provisions	Both IFRS and US GAAP use the phrase "probable" in relation to recognition of provisions for future liability. US GAAP convention applies a 75% likelihood threshold for recognition but IFRS applies 50% likelihood (ie more likely than not).
	Discounting provisions	IFRS requires provisions to be recognised at their present value. US GAAP permits (as an accounting policy choice) discounting in the case that the amount of the liability and required cash flows are fixed or determinable.
	Provisions measurement	When no amount in a range of expected outcomes is better than any other amount, US GAAP requires provision at the low end of the range whereas IFRS requires the midpoint of the range be used.
	Onerous contracts	IFRS requires recognition of an onerous contract provision any time a contract is onerous (ie future costs likely to outweigh any future revenues from the contract). US GAAP requires recognition only in respect of contract terminations or costs incurred without economic benefit following cessation of use of an asset.
Tax	Deferred tax presentation	IFRS generally requires deferred taxes to be presented as noncurrent assets/liabilities while US GAAP presentation follows the underlying asset/liability (as current or non-current) or anticipated reversal period.
	Deferred tax assets (DTAs)	US GAAP requires DTAs to be presented in full but reduced by a valuation allowance if management expect that not all of the DTA will be realised. DTA are recognised under IFRS only to the extent that it is probable that the DTA will be utilised.
	Deferred tax offsetting	US GAAP permits offset of deferred tax assets and liabilities within each jurisdiction while IFRS requires that these are offset only where there is a legally enforceable right to do so (within each jurisdiction).
	Effect of tax rate changes	US GAAP requires the impact of changing tax rates on deferred tax assets and liabilities flow through the P&L while IFRS requires the impact to be allocated to equity where the original DTA/DTL was recognised in equity.
	Interim reporting	US GAAP interim reports use the estimated worldwide effective tax rate while IFRS requires (to the extent practicable) that tax is estimated for each relevant jurisdiction.

Source: PwC, SEC, Citi Research

Figure 9. US GAAP and IFRS comparison part 2

Topic	Sub-topic	Difference
Pensions	P&L expense calculation	■ IFRS (IAS 19 R) requires the pension financial income/expense be calculated by applying the discount rate to the opening deficit position. US GAAP requires companies to recognise an expected return on plan assets and an interest charge on plan liabilities.
	Treatment of actuarial losses	■ IFRS requires immediate recognition of actuarial gains/losses in equity without recycling to P&L. US GAAP requires either immediate recognition in the P&L or deferral within equity with recycling into the P&L.
	Asset ceiling	■ There is no asset ceiling restriction in US GAAP. IFRS restricts recognition of a pension surplus as an asset to the extent that future refunds or contribution reductions will be available.
Financial instruments	Financial instruments classification	■ Classification driven by legal form under US GAAP but by underlying substance in IFRS.
	FX on AFS debt securities	■ US GAAP requires the total change in fair value of AFS debt securities be recorded within OCI. IFRS requires the FV change and FX element be split, with FX included in P&L (and FV in OCI).
	Equity accounted investments	■ US GAAP includes a FV option for equity accounted assets for all preparers. Under IFRS this is restricted to investment entities (VC, unit trusts).
	AFS debt securities impairment	■ US GAAP model based on assessment of whether diminution in value is temporary or permanent, with two triggers: (1) management intends to or will need to sell before recovery of cost and (2) management does not expect to recover the entire cost basis of the security.
	Held to maturity (HTM) debt securities impairment	■ Impairment triggers as with AFS securities. Impairment under only step (2) above expected under US GAAP; impairment measured as with AFS but recognised in equity initially and recycled into P&L over remaining life of the security. Under IFRS impairment measurement is based on the present value of the estimated future cash flows discounted at the original effective interest rate of the security (basing impairment on FV is permitted as a practical expedient).
	Impairment reversal	■ US GAAP permits impairment reversals only for loan assets. Impairment of debt or equity securities may not be reversed. An increase in expected recoveries from an impaired debt security may be accounted for through a prospective yield adjustment. IFRS permits impairment reversals through the income statement for loans and debt securities (not equity).
	Derecognition	■ Differing criteria for derecognition of financial assets (eg securitisations, factoring). Full derecognition more common under US GAAP than IFRS. IFRS includes provisions requiring continuing recognition to the extent that the company is exposed to changes in the value of the transferred asset.
	Mezzanine equity	■ Certain securities (eg puttable shares) are classified as mezzanine equity under US GAAP. There is no equivalent category in IFRS. Such assets are likely to be treated as liabilities under IFRS.
	Offsetting	■ US GAAP permits derivative assets and liabilities to be offset on balance sheet where a master netting agreement is in place. IFRS does not permit offsetting on the basis of master netting agreements, further criteria must be fulfilled.
Consolidation	Consolidating subsidiaries	■ IFRS consolidation based on de facto control rather than strictly voting rights. US GAAP consolidation is based on actual voting rights except where contractual agreements result in effective control by a shareholder without a majority holding.
	Consolidation exemption	■ US GAAP provides an exemption from consolidating controlled companies for investment companies and broker/dealers. A similar exemption in IFRS will take effect in 2014.
	JVs	■ US GAAP requires equity method accounting for JVs (with certain exceptions). Current IFRS (IAS 31) allows choice between equity method or proportionate consolidation. New IFRS (IFRS 11) requires proportionate consolidation of joint operations (where the investors have rights to individual assets and liabilities within the venture) and otherwise requires use of the equity method.
	Associates	■ When an associate company year-end differs from the parent, IFRS requires adjustment for significant events between the associate and parent's reporting date while US GAAP requires only disclosure of these events.
	Equity method investments	■ Equity method investment losses in excess of balance sheet carrying value (ie investment carried at negative value) are recognised in US GAAP when the investee appears to be assured of an imminent return to profitability, while additional losses are only recognised under IFRS to the extent the parent has a legal or constructive obligation.
	Equity method - gain on purchase	■ IFRS permits recognition of a day one gain on acquisition of an equity method investment (when the fair value of net assets acquired exceeds consideration paid). US GAAP requires such gains to be amortised over an asset's useful life or to be recognised on disposal where amortisation is not appropriate.
	Equity method investments - loss of control	■ US GAAP does not record a gain/loss on the residual asset following loss of significant influence or joint control of an equity method investment; the residual asset is measured based on the carrying value of the asset when influence/control was lost. IFRS requires a retained interest to be measured at fair value (if classified a financial asset) and therefore a gain or loss may be recognised on the residual asset.
Business combinations	Acquired contingencies	■ IFRS prohibits recognition of contingent assets on acquisition but this is permitted under US GAAP.
	Minority interests	■ US GAAP requires minorities to be measured at fair value. IFRS permits a choice between fair value and the minority's proportion of the net assets acquired.
Other	Cash flow statement	■ US GAAP excludes bank overdrafts from cash and equivalents and changes in overdrafts are therefore seen as financing cash flows. US GAAP is more prescriptive on the presentation of certain items eg interest and dividends receivable/payable.
	Diluted EPS	■ Convertible debt which can be settled in either cash or shares must be treated as being settled in shares under IFRS. US GAAP has a similar presumption but this can be overruled if past experience or stated policy suggests the debt will be cash settled.
	Diluted EPS	■ Contingently convertible shares are always included in diluted EPS calculations if dilutive under US GAAP. IFRS requires inclusion of such shares only when the contingency (eg share price at a certain level) has been met.
	Interim reporting	■ US GAAP views interim periods as integral parts of the annual cycle and permits costs to be allocated across quarters where they benefit more than one quarter. IFRS requires a discreet period approach.
	Discontinued operations	■ IFRS includes a significance hurdle for presentation as a discontinued operation (the operation must either be a separate major line of business or geographic area of operations). Under US GAAP there is no hurdle.

Source: PwC, SEC, Citi Research

Appendix 2: Japanese GAAP & IFRS comparison

We have also compiled a list of the differences in accounting rules between IFRS and Japanese GAAP (J-GAAP) which are significant for investors. J-GAAP is closer to US GAAP than IFRS in many regards. This is not an exhaustive list, and we are happy to provide more detail in specific areas on request.

Figure 10. Japanese GAAP (J-GAAP) and IFRS comparison part 1

Topic	Sub-topic	Difference
Revenue	General	■ Less guidance in J-GAAP for various revenue accounting issues (eg accounting for multiple-element contracts).
	Recognition criteria	■ IFRS generally only allows revenue to be recognised when the risks and rewards of ownership have been transferred to the customer. J-GAAP may allow revenue to be recognised on shipping of a good whereas IFRS would require the good to have arrived and been accepted by the customer before revenue recognition.
	Construction contracts	■ J-GAAP requires that for construction contracts, revenue is recognised on a completed contract basis when percentage of completion estimates cannot be made reliably. IFRS requires revenue recognition based on the amount of recoverable cost incurred in this case.
	Sales discounts and customer loyalty programmes	■ Under J-GAAP, sales discounts are included within expenses, while under IFRS they are deducted from revenues. Similarly, customer loyalty programme costs are shown as costs under J-GAAP but treated as deferred revenue in IFRS.
Expenses	Extraordinary items	■ J-GAAP permits extraordinary items. IFRS does not, although companies should disclose separately important items. Extraordinary items in J-GAAP excluded from ordinary income.
	Borrowing costs	■ IFRS requires that borrowing costs arising from the construction of long-term assets are capitalised, whereas J-GAAP requires these costs to be expensed in most cases.
Non-financial assets	Intangible assets	■ IFRS permits revaluation of intangible assets (if determined by reference to active market). J-GAAP does not.
	Impairment of non-financial assets	■ IFRS impairment is determined by comparing the carrying amount with the recoverable amount. J-GAAP impairment has two-step process. Firstly compare carrying values with undiscounted cash flows to determine if impairment exists. If impaired, measure by comparing carrying amount to fair value.
	Impairment reversals	■ IFRS permits impairment reversals for non-financial assets (excluding goodwill) and J-GAAP does not.
	Development costs	■ J-GAAP does not permit capitalisation of development costs aside from in the case of software development for sale to third parties. IFRS requires capitalisation of development costs if criteria are met.
	Property, plant & equipment (PPE)	■ Under IFRS some subsequent replacement costs etc are capitalised as part of PP&E. In some cases under J-GAAP a provision is recorded in advance for such costs and they are not capitalised as part of PP&E.
	Depreciation	■ Depreciation methods may differ between J-GAAP and IFRS, eg IFRS requires separate component level depreciation whereas J-GAAP does not (e.g. land and buildings).
	PPE revaluation	■ IFRS permits revaluation of tangible assets. J-GAAP does not.
	Investment properties	■ No equivalent to investment property accounting (fair value through P&L) in J-GAAP where the cost method applies.
Non-financial liabilities	Provisions	■ J-GAAP generally requires a higher likelihood of liability for recognising a provision than IFRS (eg IFRS 50% probability whereas approx 75% for J-GAAP).
	Holiday pay provision	■ J-GAAP does not require a provision for holiday leave pay but IFRS does.
Pensions	P&L expense calculation	■ IFRS requires the pension financial income/expense be calculated by applying the discount rate to the opening deficit position. J-GAAP requires companies to recognise an expected return on plan assets and an interest charge on plan liabilities.
	Treatment of actuarial losses	■ IFRS requires immediate recognition of actuarial gains/losses in equity without recycling to P&L. J-GAAP requires either immediate recognition in the P&L or deferral within equity with but amortisation into the P&L.
Financial instruments	General	■ While J-GAAP is fairly similar to IFRS, there are numerous detailed differences and in general J-GAAP is more driven by legal form.
	Classification as financial liability or equity	■ Some instruments such as preferred shares may be classified as equity under J-GAAP but as liabilities under IFRS. Similarly the dividend on such instruments would qualify as an interest charge in IFRS.
	Convertible debt	■ J-GAAP allows convertible debt to be treated only as a liability while IFRS requires that it should be split between debt and equity components.
	Fair value option	■ IFRS provides option for instruments to be measured at FV through P&L. No such option in J-GAAP.
	Offsetting	■ J-GAAP permits derivative assets and liabilities to be offset on balance sheet where a master netting agreement is in place. IFRS does not permit offsetting on the basis of master netting agreements

Source: PwC, E&Y, Citi Research

Figure 11. Japanese GAAP (J-GAAP) and IFRS comparison part 2

Topic	Sub-topic	Difference
Consolidation	Off balance sheet treatment	■ It is easier to get off-balance sheet treatment for special purpose vehicles under J-GAAP than IFRS.
	JVs	■ J-GAAP requires equity method accounting for JVs. Current IFRS (IAS 31) allows choice between equity method or proportionate consolidation. New IFRS (IFRS 11) requires proportionate consolidation of joint operations (where the investors have rights to individual assets and liabilities within the venture) and otherwise requires use of the equity method.
Business combinations	Goodwill	■ Japanese GAAP requires amortisation of goodwill over up to 20 years. IFRS does not permit amortisation of goodwill (though other acquisition intangible assets are usually amortised).
	Restructuring liabilities	■ J-GAAP allows provision for restructuring liabilities as part of acquisition accounting (ie adjusted against goodwill), which IFRS generally does not allow.
	Contingent consideration	■ IFRS requires contingent consideration to be recognised at fair value on the point of acquisition. J-GAAP does not require contingent consideration to be recognised until the transfer or payment of the contingent consideration becomes substantive.
	Minority interests	■ J-GAAP requires minorities to be measured as the minority's proportion of the net assets acquired. IFRS permits a choice between fair value and the minority's proportion of the net assets acquired.
Other	P&L presentation	■ J-GAAP requires expenses to be presented by function (eg cost of sales, SG&A, etc) whereas IFRS permits split by nature (employee benefits, depreciation, etc) or by function.
	Dividend presentation	■ Dividends classified as non-operating income under J-GAAP but finance income under IFRS.
	Changes in accounting policy/ correction of errors	■ IFRS generally requires retrospective application of changes in accounting policy or error corrections. Under J-GAAP, the impact of such items is generally included as extraordinary items within current year net income.
	Discontinued operations	■ Under J-GAAP discontinued operations are not segregated separately on the P&L whereas under IFRS major discontinuing businesses are presented separately and not included in results from continuing businesses.

Source: PwC, E&Y, Citi Research

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Notes

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Appendix A-1

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