Recent Developments in IFRS

IFRS has become the global language of financial reporting with its adoption by over 100 countries. The IFRS Standards are continuously evolving with the IASB issuing several new standards in the recent past. In this article, we shall understand the key requirements of the new Standards - IFRS 10 to 12 relating to Consolidation, IFRS 13 relating to Fair Value Measurement and amendments to IAS 19 on Employee Benefits which have become effective during the year 2013. In addition, we shall understand the significant requirements in the Exposure drafts released relating to Standards on Revenue recognition, Leases and Financial Instruments.

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In this era of globalisation, it has become the need of the hour that companies across the globe and more particularly the listed companies should use a common set of accounting principles which would help investors to assess the performance of companies. International Financial Reporting Standards or IFRS is required or permitted for use by more than 100 countries across the globe.

Since IFRS has become the global language of financial reporting, International Accounting Standards Board or IASB, the standard setting body for IFRS, has been in dialogue with the stakeholders around the globe and have been making amendments to existing Standards, introducing new Standards and also undertaking convergence project with the Financial Accounting Standard Board or FASB in the US, to develop accounting standards which can be universally accepted.

The developments in IFRS over the past 12 months can be broadly classified as follows:

1 New IFRS Standards 10 to 12 relating to Consolidation, IFRS 13 relating to Fair Value Measurement and amendments to IAS 19 on Employee Benefits which have become effective during the year 2013; and

2 Exposure drafts relating to Standards on Revenue recognition, Leases and Financial Instruments which have been released and are expected to be finalized in the current year.

The current work plan for 2013 released by the IASB for the major IFRSs for which Exposure Drafts (ED) has been released and which we would be discussing

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in this article is as follows:

Sr No.	Name of the Exposure Draft of the Standards	Timeline
1	Revenue Recognition	Final Standard in Q3 of 2013
2	Financial Instruments: • Classification and Measurement • Impairment • Hedge Accounting	• Redeliberations to be done • Redeliberations to be done • Final Standard in Q3 of 2013
3	Leases	Redeliberations in Q4 of 2013

Further, post implementation review for IFRS 10 to 12 would be in 2016, for IFRS 13 in 2015 and for amendments to IAS 19 in 2015. A post implementation review normally begins after the new requirements have been applied internationally for two years, which is generally 30 to 36 months after the effective date.

New IFRS Standards

We shall now understand the key requirements of IFRS Standards which have become effective in 2013, applicable for periods beginning on or after 1st January 2013.

IFRS 10 – Consolidated Financial Statements

IFRS 10 on Consolidated Financial Statements provides a revised definition of control and related guidance. It replaces IAS 27 Consolidated and Separate Financial Statements and SIC 12 Consolidation – Special purpose entities and applies to all investees.

Under IFRS 10, the investor, regardless of the nature of its involvement with an entity (the investee), shall determine whether it is a parent by assessing whether it controls the investee. As per IFRS 10, an investor controls an investee when it is exposed, or has rights to variable returns from its involvement with the investee and has the ability to affect those returns through its power over the investee. An investor controls an investee if and only if the investor has all the following:

a) power over the investee which is demonstrated when the investor has existing rights that give it the current ability to direct the activities that significantly affect the investee's returns. Power can be the result of voting rights acquired from equity shares or from contractual arrangements;
b) exposure, or rights, to variable returns from its involvement with the investee; and
c) the ability to use its power over the investee to affect the amount of the investor's returns.

From the above, it is clear that IFRS 10 introduces a single control model for all entities, including Special Purpose Entities. It is likely to be a difficult standard to apply across many sectors. This is because the Standard provides a series of indicators of control, without providing a hierarchy to be followed. One is required to understand the design and purpose of the investee and take into account evidence of power, which would entail application of significant judgement in making the control assessment.

The key impact of the above is that investees previously accounted for using equity accounting or as financial instruments may require consolidation. Further, previously unconsolidated entities that have significant relationships with the entity may now require consolidation. Entities in the financial services sector (excluding an investment entity) are expected to be impacted the most, and to a lesser extent those in the real estate sector. Also entities in the infrastructure and energy sectors where rights other than voting rights are relevant in assessing control may be impacted.

An amendment to IFRS 10 provides a mandatory consolidation exception to a qualifying investment entity which is required to account for investments in controlled entities – as well as investments in associates and joint ventures – at fair value through profit and loss. The only exception would be subsidiaries that are considered an extension of the investment entity's investing activities.

IFRS 10 is applied retrospectively when there is a change in the control conclusion. There are specific requirements when retrospective application is impracticable.

IFRS 11 – Joint Arrangements

Under IFRS 11 Joint Arrangements, joint arrangements are essentially defined in the same way as under IAS 31 Interests in Joint Ventures – as an arrangement over which there is a joint control. IFRS 11 sub-categorises joint arrangements into joint operations and joint ventures.

A joint arrangement is defined as an arrangement of which two or more parties have joint control. A joint arrangement has the following characteristics:

a) The parties are bound by a contractual arrangement.
b) The contractual arrangement gives two or more of those parties joint control of the arrangement.

A joint arrangement is either a *joint operation* or a *joint venture.*

Joint control is the contractually agreed sharing of control of an arrangement, which exists only when decisions about the relevant activities require the unanimous consent of the parties sharing control.

An entity shall determine the type of joint arrangement in which it is involved. The classification of a joint arrangement as a joint operation or a joint venture depends upon the rights and obligations of the parties to the arrangement.

- A joint operation is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement. Those parties are called joint operators.
- A joint venture is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement. Those parties are called joint venturers. A joint venturer shall recognise its interest in a joint venture as an investment and shall account for that investment using the equity method.

Although there may not be across-the-board change in classification, on transition to IFRS 11, all joint arrangements will need to be re-assessed. As the classification of a joint arrangement requires identification and assessment of the structure, legal form, contractual arrangement and other facts and circumstances, this is expected to be an area of judgement that requires careful consideration in practice.

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Not all jointly controlled entities under IAS 31 will be joint ventures under IFRS 11. Transitioning from proportionate consolidation to equity method can affect all financial statement line items, notably decreasing revenue, gross assets and gross liabilities. This change is expected to have a widespread impact since significant number of IFRS users account for joint ventures using the proportionate consolidation method of accounting. It is also expected that industries in the extractive and real estate sector would be particularly affected because of the prevalence and complexity of joint arrangements.

IFRS 12 – Disclosure of Interest in Other Entities

IFRS 12 Disclosure of Interest in Other Entities is basically a disclosure standard. It requires an entity to disclose:

(a) the significant judgements and assumptions it has made in determining the nature of its interest in another entity or arrangement, and in determining the type of joint arrangement in which it has an interest; and
(b) information about its interests in:
    (i) subsidiaries;
    (ii) joint arrangements and associates; and
    (iii) structured entities that are not controlled by the entity (unconsolidated structured entities). A structured entity is an entity that has been designed so that voting or similar rights are not the dominant factor in deciding who controls the entity, such as when any voting rights relate to administrative tasks only and the relevant activities are directed by means of contractual arrangements.

The objective of this IFRS is to require an entity to disclose information that enables users of its financial statements to evaluate:

(a) the nature of, and risks associated with, its interests in other entities; and

(b) the effects of those interests on its financial position, financial performance and cash flows

It is expected that the impact of this Standard would be the most on entities which have interests in unconsolidated structured entities. Investment funds and asset-backed financing are common examples of entities that might be structured entities.

IFRS 13 – Fair Value Measurement

IFRS 13 Fair Value Measurement replaces existing guidance in individual IFRSs. It provides a revised definition of fair value and related guidance as well as an extensive disclosure framework.

IFRS 13 establishes:

- a single definition of fair value (FV)
- a framework for measuring FV
- disclosure requirements for FV measurements

IFRS 13 does not require additional FV measurements in addition to those already existing

IFRS 13 defines fair value 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. Thus fair value measurement is based on the exit price and market participant view.

The impact of this Standard is that ssignificantly more disclosures would be required in financial statements and may involve significant judgement and estimation uncertainty to arrive at the fair value.

IAS 19 – Employee Benefits Amended

Certain Amendments were also made in IAS 19 – Employee Benefits. However, there are no changes to fundamental measurement method under which benefits are attributed to periods of service.

The major amendments pertain to the fact that under the amended Standard, all actuarial gains and losses are recognised immediately in other comprehensive income. The option available under the earlier Standard to apply the corridor method or to recognise the amount in the profit and loss account for actuarial gains and losses is removed.

The Standard prescribes revision in the calculation for finance costs. Net interest cost is now calculated as the net defined benefit liability (asset) multiplied by the discount rate that is used to measure the defined benefit obligation, and the difference between the expected rate of return on the plan assets and the rate used to discount the existing obligation is recognised in other comprehensive income. The nature of the plan assets held will have no impact on the net finance charge or credit. The impact of this change will be greater, when the gap between the expected rate of return on plan assets and the rate used to discount the obligation is greater. This change might lead to a rebalancing of investment portfolios.

Companies would also be required to evaluate the classification of short-term and other long-term employee benefits based upon when the employee benefit is 'expected' to be settled.

The above represents the key developments in Standards which are applicable during 2013.

In addition to the above significant developments, IASB regularly undertakes narrow-scope amendments to the existing standards based on the feedback received from the stakeholders to address practical issues and inconsistencies, if any.

Exposure Draft of Standards

We shall now take a look at the Exposure Drafts on Revenue, Leases and Financial Instruments which are expected to significantly change the manner in which these transactions / instruments are accounted for as per the existing IFRS standards.

Exposure Draft on Revenue from Contracts with Customers

The IASB and FASB have recently jointly released an exposure draft on Revenue from Contracts with customers. The ED does not propose a specific effective date but mentions that would be applicable no earlier than annual periods commencing on 1st January 2015. The ED proposes that a single revenue standard would apply to all contracts with customers under IFRS and US GAAP.

As per the Exposure Draft, entities would recognise revenue based on a 5-step analysis, focussing on transfer of control.

Step 1—Identify the contract with a customer.

Step 2—Identify the separate performance obligations in the contract.

Step 3—Determine the transaction price.

Step 4—Allocate the transaction price to the separate performance obligations in the contract.

Step 5—Recognise revenue when (or as) the entity satisfies a performance obligation.

There are two ways to recognise revenue within the model. Revenue may be recognised over time, similar to current stage of completion accounting, or at a point in time, similar to current sales of goods accounting. The ED proposes new criteria to determine when revenue should be recognised over time.

The key impacts which this ED is expected to have are:

- Revenue may be recognised at a point in time or over a period of time.
- For complex transactions with multiple deliverables and/or variable consideration, revenue recognition may be accelerated or deferred
- Extensive new disclosure requirements about business practices and prospects
- Changes may be required to the IT system to capture data to comply with the new requirements.
- Bonus structures and contract terms may be required to be revisited to align them to the corporate goals. Also debt covenants may be impacted.

Exposure Draft IFRS 9 Financial Instruments

IFRS 9 on Financial Instruments would be applicable for annual periods commencing on 1st January 2015. Although currently IAS 39 on *Financial Instruments: Recognition and Measurement* sets out the requirements for recognising and measuring financial assets and financial liabilities, many users of financial statements communicated to IASB that the requirements in IAS 39 were difficult to understand, apply and interpret. The Board was urged to develop a new standard for the financial reporting of financial instruments that was principle-based and less complex. IASB intends to replace the entire IAS 39 with IFRS 9. However, to respond to the users as quickly as possible, it was decided to replace IAS 39 in three phases:

Phase 1: Classification and measurement of financial assets and financial liabilities (limited amendments)

Phase 2: Impairment methodology

Phase 3: Hedge accounting.

ED on limited amendments to classification and measurement

Under the ED relating to limited amendments to classification and measurement, financial assets are measured at fair value through profit and loss unless certain conditions are met requiring the use of amortised cost. Changes in certain equity investments may be presented in OCI. Guidance on financial liabilities has remained mostly unchanged.

A financial asset qualifies for amortised cost measurement only if it meets both of the following conditions:

- the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows; and
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding.

If a financial asset does not meet both of these conditions, then it is measured at fair value with fair value changes generally recognised in profit or loss.

It is therefore, expected that under the standard, process for determining classification of financial assets will need revision.

ED on Amortised cost and impairment

The ED on Amortised cost and Impairment lays down measurement proposals that apply to both financial assets and financial liabilities stated at amortised cost. The impairment proposals apply to financial assets measured at amortised cost.

ED on Hedge accounting

The ED relating to hedge accounting, is a more principles-based standard that aligns hedge accounting more closely with risk management. It includes new requirements to achieve, continue and discontinue hedge accounting. Further, additional exposures may qualify as hedged items

Some of the key differences compared to IAS 39 includes introducing new fair value option model for managing credit risk, and alternative fair value option model for certain own-use contracts. Additionally, time value of purchased options and forward element of forward contracts may be deferred or amortised. The new ED also requires additional disclosure requirements regarding an entity's risk management and hedging activities.

Exposure Draft on Leases

The IASB and FASB have jointly released an exposure draft (ED) on Leases recently. The ED does not propose a specific effective date. The comments period for this standard would end on 13th September 2013.

Under the proposals, lessees and lessors would apply a new lease classification test. The classification criteria would be based on the nature of the underlying

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asset and the extent to which the asset is consumed over the lease term. The ED proposes a dual accounting model, as follows:-

An entity would classify every lease as either a Type A or a Type B lease.

Lease classification would depend on the nature of the underlying asset and the extent to which it is consumed over the lease term. There is a distinction between underlying assets that are property – i.e. land and/or a building – and non-property. If a separate lease component contains a lease of more than one underlying asset, then the entity would classify the lease according to the nature of the primary asset.

Underlying asset	Lease classification
Non-property i.e not land or a building	**Type A, unless:** • the lease term is for an insignificant part of the total economic life of the underlying asset; or • the present value of the lease payments is insignificant relative to the fair value of the underlying asset.
Property i.e. land and/or a building	Type B, unless: • the lease term is for the major part of the remaining economic life of the underlying asset; or • the present value of the lease payments accounts for substantially all of the fair value of the underlying asset.

A lease is classified as Type A if the lessee has a significant economic incentive to exercise an option to purchase the underlying asset.

Accounting by lessees:

Lessees would recognise Type A and Type B leases 'on-balance sheet'. In each case, the lessee would recognise:

- a right-of-use (ROU) asset – representing its right to use the underlying asset during the lease term; and
- a lease liability – representing its obligation to pay lease rentals.

In a Type A lease, the profile of total lease expense (amortisation of the ROU asset plus interest on the lease liability) would often be front-loaded.

In a Type B lease, the lessee would measure the ROU asset as a balancing figure – to achieve a straight-line profile of total lease expense.

Accounting by lessors:

Lessors in a Type A lease would derecognise the underlying asset on lease commencement and recognise:

- a lease receivable – representing its right to receive lease payments from the lessee; and
- a residual asset – representing its interest in the underlying asset at the end of the lease term.

Lessors in a Type B lease would apply a model similar to current operating lease accounting.

Further in case of short term leases, both lessees and lessors could elect a simplified approach. Short-term leases are. leases with a maximum contractual term, including renewal options, of 12 months or less. Under the proposals, any lease that contains a purchase option is not a short-term lease.

Under the simplified approach, the lessee/lessor would recognise lease payments as expense/income in profit or loss, similar to current operating lease accounting.

The key impacts which this ED is expected to have are:

- Data extraction from lease agreements and identification of the lease for appropriate accounting
- Significant impact on the balance-sheet on both assets and liabilities
- New estimates and judgement required for identification, classification and measurement of lease transactions
- New systems and processes may be required to be developed to quantify and account
- Contract terms and business practices may be affected.

To summarise, extensive efforts are being made to improve financial reporting by companies across the globe. As can be seen from the above, due to the global adoption of IFRS standards, most of the Standards lays down principles which require analysis of the facts and circumstances and application of significant judgement. Although, based on the feedback received from the various stakeholders, IASB comes up with interpretations and clarifications on a regular basis, however, due to the exercise of significant judgement, practical implementation of the Standards is expected to be a challenging area not only for the management of the companies but also for its auditors. ■