

RSM Reporting

**Welcome from
the Editor**
Marco Mongiello

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

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There are many ramifications to the introduction of a new standard; technical issues and philosophical questions, which address whether the informational value of the accounts has been improved and whether more complexity or some simplification has been introduced.

These effects are magnified when, rather than a standard, an altogether new set of standards starts to be implemented. Hence, Christian Kampmeyer addresses some of the technical debate around the introduction of a new standard, IFRS 9 (announced in this newsletter - Issue 3, March 2010), Jeff Pellarin reflects on the informational value of the Balance Sheet, and our guest contributors Michael Izza (CEO of the Institute for Chartered Accountants in England and Wales - ICAEW) and Marianne Mau (ICAEW Technical Manager, Financial Reporting Faculty) share their opinions about the implementation of IFRS for SMEs.

Talking about IFRS for SMEs at this point in time also means touching base on its success a year after its first announcement in this newsletter (Issue 2, October 2009). We are very fortunate to do this with the contribution of the aforementioned guests, who hold a privileged position for observing and indeed influencing decisions with respect to international reporting.

This edition also sees a change of author for the TopTenTopics section; as Stefano Bianchi has left RSM, Joelle Moughanni, a technical manager in the RSM Executive Office, takes over this section from him. We thank Stefano, whose contributions to the newsletter has been invaluable, and went well beyond the precious insights he has proposed on selected (and particularly challenging) reporting topics. We welcome Joelle, who is not new to the newsletter either, as she has already helped in its editorial process. Her kind willingness to take a more prominent role allows us to benefit from her professional abilities and experience.

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Accounting and Reporting this Quarter

IASC/IASB

>> go to www.ifrs.org to follow up any of the following news

August 2010

The IASB and FASB published an Exposure Draft (ED) on lease contracts. The accounting under current provisions depends on the classification of a lease. Classification as an operating lease results in the lessee not recording any assets or liabilities in the statement of financial position. This results in many investors having to adjust the financial statements for the purpose of investment analysis.

The proposals would result in a consistent approach to lease accounting for both lessees and lessors—a 'right-of-use' approach.

Commenting on the ED, Sir David Tweedie, chairman of the IASB, said: "The leasing industry plays an important role in many economies by helping companies manage cash flow and working capital. However, much of the estimated annual \$640 billion of lease commitments fails to appear on the balance sheet of lessees, thereby giving a false impression of companies' liabilities and gearing.

Our proposals would result in better and more complete financial reporting information about lease contracts being available to investors and others."

Bob Herz, chairman of the FASB, said: "This proposal continues the progress both boards are making to improve and converge our standards in significant areas of accounting. The proposal is intended to improve the transparency of lease accounting and also decrease its current complexity. I encourage all constituents that engage in leasing transactions to provide us with your views on this important proposal."

NB: the boards are seeking entities that would be willing to take part in field work to discuss and test the provisions of their proposals for lease accounting .

Deadline: 15th September 2010.

July 2010

The IASC Foundation formally changed its name to the IFRS Foundation.

The change represents the next step in a process to simplify the names in use across the organisation. The International Financial Reporting Interpretations Committee (IFRIC) and the Standards Advisory Council (SAC) have already been renamed as the IFRS Interpretations Committee and the IFRS Advisory Council, respectively.

The name of the International Accounting Standards Board (IASB) will remain unchanged.

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The IASB has published the Exposure Draft (ED) of improvement to the accounting insurance contracts open for comments until the end of November 2010. The ED proposes a single International Financial Reporting Standard (IFRS) that all insurers, in all jurisdictions, could apply to all contract types on a consistent basis. This can be summarised as a single measurement model that focuses on a current assessment of the amount, timing and uncertainty of the future cash flows that the insurer expects its existing insurance contracts to generate as it fulfils them. The proposed measurement model uses 'building blocks' to measure an insurance liability: current estimates of future cash flows, time value of money, risk adjustment and residual margin.

This ED is the result of almost a decade long consultation process that has involved the IASB and US Financial Accounting Standards Board (FASB) and many constituencies. This ED aims at replacing IFRS 4, introduced by the IASB in 2004 as an interim standard that permitted many existing international accounting practices to be retained.

June 2010

The IASB and the FASB published, for public comment until October 2010, a Draft Standard (DS) to improve and align the financial reporting of revenue from contracts with customers and related costs.

If adopted, the proposal would create a single revenue recognition standard for IFRS and US generally accepted accounting principles (GAAP) that would be applied across various industries and capital markets for all contracts with customers except leases, financial instruments and insurance contracts.

The DS proposes a five-step plan to revenue recognition:

1. Identify the contract with the customer
2. Identify the separate performance obligations
3. Determine the transaction price
4. Allocate the transaction price to the performance obligations
5. Recognise revenues when a performance obligation is satisfied

The publication of this joint proposal represents a significant step forward toward global convergence as it would replace IAS 18 Revenue and IAS 11 Construction Contracts, and supersede most of the guidance on revenue recognition in Topic 605 of the FASB Accounting Standards Codification.

Accounting and Reporting this Quarter

EFRAG

>> go to www.efrag.org to follow up any of the following news

August 2010

EFRAG published a questionnaire inviting responses from preparers relating to the impact on specific industries of the proposals in the IASB's ED Revenue from Contracts with Customers.

While EFRAG may agree with the IASB that the proposals in the ED have the potential of improving the financial reporting in the area of revenue recognition, EFRAG believes that such improvement does not in itself justify the fundamental change made to the revenue recognition model. A change in the revenue recognition model may prove costly for both preparers and users of financial statements. EFRAG believes that these costs should be justified (see below).

EFRAG therefore is undertaking an outreach programme to understand more clearly the impact of the proposal in the ED on specific industries. As part of the consultation, EFRAG has designed a questionnaire that can be downloaded from its web page. The questionnaire includes a number of broad questions designed to provide structure to interviews with preparers.

If you would like to participate, please contact one of the EFRAG staff indicated in their web page and forward a written response to the questionnaire.
Deadline: 22nd September 2010.

July 2010

EFRAG published a letter of partial endorsement of the ED on Revenue Recognition (see news from IASB). EFRAG is nevertheless very critical about important contents of the ED and is triggering a survey among its constituents (see above).

EFRAG published a letter of endorsement of the conceptual approach of the ED on Financial Instruments: amortised costs and impairment. EFRAG is still quite critical about the operational concerns of the ED.

June 2010

EFRAG has updated its position regarding IFRS for SMEs' compatibility with the EU Accounting Directives. This position now includes only some issues that refer to goodwill, fair value and extraordinary items as not compatible.

EFRAG published a letter of comments on the IASB's ED Presentation of Items of Other Comprehensive Income. EFRAG strongly objects to the IASB's initiative to remove the option of presenting performance in two statements, because this proposal would not result in any change or improvement to the current financial reporting. However, EFRAG is supportive overall of the proposal to separately present items of other comprehensive income that are reclassified to profit or loss (recyclable) and those that are not reclassified to profit or loss (non-recyclable); and to allocate income tax to separate groups of other comprehensive income.

1 News and Updates



Marco Mongiello IFRS for SMEs is gaining momentum

Milestones

Objectives:

- > To make IFRS for SMEs a truly global standard

Current status:

- > IFRS for SMEs was published in July 2009

What's next:

- > Adoption of the IFRS for SMEs in several jurisdictions is under way.

In the October 2009 edition of RSM Reporting we reported on the publication of the IFRS for SMEs. Almost a year on, it is now time to touch base on the success of this new standard. The section "Recent adoptions of the IFRS for SMEs" of the monthly "IASB's IFRS for SMEs Update", published by the IASB since March 2010, tells a story of a contagious popularity and global spread of adoption of the standard. March has seen eight new jurisdictions added to the list of over 50 jurisdictions that had already adopted (or were on the way to adopt) the standard at that point in time; April, listed six new jurisdictions; May, four new jurisdictions. Although July and August have not seen new jurisdictions joining the new standard, the pace of the spread of this new standard was such that at this year's annual IASC/IFRS Foundation Conference, Mr Paul Pacter* said "I can never be sure of the exact number of jurisdictions en route to adopting the standard at any point in time, as the count keeps rolling on a daily basis." Also, there are different paces by which each jurisdiction elects to reach full adoption of the IFRS for SMEs, spanning from South Africa's pioneering unconditional adoption, to the UK's extensive consultation process, which might lead to the adoption in 2013.

There appears to be a pattern and, as it always goes, some exceptions to the global spread of IFRS for SMEs. The pattern is that jurisdictions with weaker extant GAAPs tend to be faster in adopting the IFRS for SMEs, in many cases because they see the new standard as a way for smaller entities to opt out from the use of full IFRS, which can prove cumbersome for them. The exceptions are quite intriguing though with, for example, the US having already made the IFRS for SMEs available for use without any action, whilst the EU is still consulting on the adoption of IFRS for SMEs. The UK case is emblematic of a jurisdiction where users and preparers have to be convinced that it is worthwhile departing from existing standards for smaller entities, which seem to have worked very well so far. Equally emblematic is the Australia case, where IFRS for SMEs will not be adopted in the foreseeable future, with the Australian Accounting Standards Board preferring to refine its existing differential reporting framework.

What makes the IFRS for SMEs so popular is that: it is all contained within 230 pages, it is simplified but built on IFRS foundation, it is a stand-alone set of standards designed for SMEs, and it is internationally recognised and constitutes a stable platform. With hindsight, though, some of these features appear to be more relevant than others, as we explore in the next few pages of this newsletter.

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Patrick Wright Conceptual framework for financial reporting - the reporting entity



Milestones

Objectives:

- > To define a Reporting Entity in the context of the Conceptual Framework project, which aims to update and refine the existing concepts to reflect the changes in markets, business practices and the economic environment that have occurred in the two or more decades since the concepts were first developed. The overall objective is to create a sound foundation for future accounting standards that are principles-based, internally consistent and internationally converged.

Current status:

- > Exposure Draft comment letter period closed last July.

What's next:

- > This ED constitutes phase D of the Conceptual Framework project, which is subdivided in eight phases from A to H.
- > The Final Chapter of phase D (Reporting Entity) is expected by the end of this year.

As part of phase A of the Conceptual Framework Project "Objectives and Qualitative Characteristics" being promulgated jointly by the IASB and the FASB, a key objective of general purpose financial reporting is identified as providing financial information about the reporting entity that is useful to stakeholders when making decisions. The definition of who constitutes the reporting entity therefore becomes critical.

To further this project and to examine why the existing concept of an entity might be flawed, the IASB and the FASB jointly issued an Exposure Draft (ED) looking at ways in which an improved conceptual financial reporting framework could be introduced insofar as it relates to the identification of the reporting entity.

The ED proposes that a reporting entity 'is a circumscribed area of economic activities whose financial information has the potential to be useful to existing and potential equity investors, lenders and other creditors who cannot directly obtain the information they need in making decisions about providing resources to the entity and in assessing whether management and the governing board of that entity have made efficient and effective use of the resources provided.'

The ED goes on to emphasise that power to control another entity, rather than strict legal form, is key to determining which entities

should be reported as a single unit in consolidated financial statements. For this purpose an entity would control another entity when it "has the power to direct the activities of that other entity to generate benefits for (or limit losses to) itself".

Do all entities constitute a reporting entity?

With a shift from current financial reporting practices the ED proposes that a portion of a single entity could qualify as a reporting entity if the economic activities of that portion can be objectively identified and its financial information could be useful in making decisions.

Conversely, a single legal entity may not represent a reporting entity when, for example, its economic activities are so commingled with the economic activities of another entity that they cannot be objectively distinguished.

What are the features of a reporting entity?

The ED identifies three features of a reporting entity:

- economic activities are being conducted, have been conducted, or will be conducted
- the economic activities can be objectively distinguished from those of other entities and from the economic environment in which the entity exists
- financial information about the economic activities has the potential to be useful to existing and potential equity investors, lenders and other creditors

What type of financial statements?

The ED requires the presentation of consolidated financial statements whenever a parent controls one or more entities. The ED does acknowledge however that combined financial statements that include two or more commonly controlled entities may provide useful information about those commonly controlled entities as a group. However, combined financial statements are no substitute for consolidated financial statements.

What happens next?

The potentially controversial nature of some of the proposals are likely to generate a great deal of commentary - but if all goes to plan the final document will be produced by the IASB in Q4 of 2010.

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2 The point of view of ...



Michael Izza and Marianne Mau ...on IFRS for SMEs*

One of the first impressions you have when you enter the London offices of the Institute of Chartered Accountants in England and Wales (ICAEW) is that a lot goes on in those elegant and dazzling premises...and rightly so, given that with its 130,000 members in more than 160 countries, the ICAEW certainly has the critical mass to globally influence the accounting practice. This role is particularly relevant given that the Institute's main responsibility is to protect the public by ensuring that members maintain the highest standards of professional conduct and competence. Among the tools which the ICAEW deploys to this end, is the dissemination of knowledge, which in turn, is the *raison d'être* of this newsletter.

When I entered the offices of the ICAEW to meet its CEO, a number of workshops and a conference were taking place. Several smaller meetings were also being held and yet each visitor was courteously welcomed and made to feel comfortable. After a short wait in the library, where other members were absorbed in their technical updating, I was approached directly by a very friendly Michael Izza, the Institute's CEO, who proudly showed me around and swiftly brought me to his office. There, a prominent member of the Institute's Financial Reporting Faculty, Marianne Mau, was ready to join in our conversation on IFRS for SMEs. The ambience, inspiring professional openness and intellectual vibe, says a lot about the Institute's approach to our profession practice...and my interviewees said the rest. I am delighted to share with our readers Michael's and Marianne's opinions on this very important topic.

Right at the beginning of our conversation Michael reset the goal post with: "Since the audit exemption threshold began to be introduced in the UK, the majority of the SMEs in this country no longer have to have an audit and, therefore, file unaudited accounts with Companies House. We have seen a deterioration of the quality of these accounts, because they are not checked. I think this is a real public policy issue. Since the Joint Stock Company was invented in Victorian times, we have a tradition of companies being audited and users being able to rely on the accounts for a true and fair view of the financial situation and performance of the reporting entities. Of the approximately 2.5 million filings a year with Companies House, only 400,000 are audited. There is a huge element not being checked and we look at the experience in other countries, where they have not had this tradition of auditing; accounts that are filed can be of low quality. I think there is a bigger issue beyond arguing about the standards; it's a public policy issue. Before I came into this job, I was managing director and finance director in a number of businesses. One of the

things that I used to ask for, from suppliers and customers, was a set of their audited accounts as part of the normal due diligence to get information about the people I was dealing with. That's increasingly not available today." Hence, if the problem is caused by the audit exemption threshold, it will not be the adoption of the IFRS for SMEs that will improve the quality of the accounts.

A second blow to the IFRS for SMEs came from Marianne, referring to one of the most mentioned features of the standards: comparability. "Comparability, for us, is 'nice to have' but is not the most important objective in terms of adopting IFRS for SMEs. The issue is maintaining comparability within the UK (and the same certainly applies to other jurisdictions). At the moment we have the IFRSs, UK GAAP and the FRSE [Financial Reporting Standards for Smaller Entities]." And, promptly Michael added "ICAEW also maintains that the FRSE should be kept for the foreseeable future. Why should we discard a piece of the financial reporting system that is functioning? Not all professional bodies supported maintaining the FRSE."

So, why are so many jurisdictions around the world adopting IFRS for SMEs? Both Marianne and Michael come to the rescue, referring to "the advantages of the IFRS for the SMEs [which] outweigh the disadvantages" (Marianne), and which seem to revolve around the key words: 'simplification', 'stability' and 'relevance'.

Admittedly, the advantages of simplification can prove so popular that, in Marianne's words, "there is a big debate to be had, when the IFRS for SMEs gets into full swing, whether we really need so much complexity in the full IFRSs, when the IFRS for SMEs seems to work very well in those situations". This was echoed by Michael "if IFRS for SMEs is seen to be a success, people will ask questions as to why the disclosures of the full IFRSs are so much longer, and so much more complicated, and if they are actually serving the needs of the investors or, in fact, they do turn out to be something the standard setter has gone too far with. I think there will be pressure to reduce the size of the IFRSs". So, the simplification borne by the IFRS for SMEs seems to be perceived as a massively important advantage, to the extent that it has the potential to backfire on the full IFRSs.

A further advantage is the relative stability offered by the IFRS for SMEs as the IASB's stated intention is to update it only once every three years. "The view of the ICAEW is that now that we've got an IFRS for SMEs, we want to change it as little as possible. We want to have something that is workable and desirable. It is important not to have

*the interview was conducted by the Editor

yet further change to the IFRS for SMEs." (Marianne). A particular weight must be attached to this consideration given that the role of the ICAEW certainly includes preventing its members from having to deal with unnecessary complexity.

What makes ICAEW still endorse the IFRS for SMEs is that it is relevant to non-publicly accountable entities. The IFRS for SMEs avoids some of the complexity of full IFRSs by requiring simplified accounting treatments and fewer options, in recognition that the needs of the SME differ from publicly accountable entities. "So whereas it may be appropriate to only include the historic cost option for properties in the IFRS for SMEs in the interests of simplicity, for publicly accountable entities, where comparability is key, it is very important that any valuations used are reliable and performed consistently wherever they are taking place. You are looking at different situations that require different sets of standards" (Marianne). And, in fact, one of the most important stakeholders of non-publicly accountable entities, banks, have confirmed that "what really matter to [them] is the cash flow, what [they] actually see going through [their] system, i.e. seeing the trading that is happening day-to-day" (Michael). We should stress, here, that the IFRS for SMEs is not for SMEs as such; rather, it is for non-publicly accountable entities and, among them, for those who do not plan to be listed in the foreseeable future and who do not see themselves as "public interest companies" (Michael). This results in a judgement-based choice that, in certain critical situations, could go against the public interest and this "is an aspect that needs to be monitored" (Michael).

A conclusion can be drawn that IFRS for SMEs will add a further piece to the jigsaw in the evolution of accounting, which can be somewhat counterintuitive, given that it represents yet another set of standards, in a context of global convergence of the worldwide accounting language. However, the simplification that underpins this new set of standards and its stability are, in the eyes of the ICAEW, so much more important.

Still an overarching question remains to be addressed: whether the role of accounting standards (be they any version of IFRSs or domestic standards) should be to contribute to reducing the economies' volatility or to report facts in the most transparent and useful possible way? The latest financial crisis has once again raised the question of the role of reporting, when mark-to-market values have been blamed for spreading economic volatility.

On this fundamental matter both my interviewees seem to have a very clear and firm position. First Marianne says "transparency is important and you want to report the facts as you see them. And then it is up to others i.e. regulators and users of the accounts, to determine how that information is to be used and what potentially additional information is required. But I think we would not look towards creating an additional role for financial reporting to prevent volatility". Michael reinforces "I feel very strongly that if regulators want particular information and data, they should ask for it. National regulators can in general get whatever they want from their regulated entities, just by asking. And when you talk to the big auditing firms, they say 'generally if the regulator wants this additional report we'll do it for them'. But let's not make complicated financial reporting even more complicated than it is already." This emphasises that the ICAEW's position, with regards to the IFRS for SMEs, is mainly concerned with the cost vs. benefit considerations and with the usefulness of the accounts for their users i.e. other public policy considerations should not be allowed to undermine good financial reporting - a principle invoked when reclaiming a wider scope of the requirement of auditing.

So, the IFRS for SMEs certainly has the blessing of one of the most prestigious and influential Accounting Professional Bodies, but, gratefully, they are not spared the Body's critical view, which helps us all, reflecting on how to contribute towards the successful development of our profession.

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2 The point of view of ...



Jeff Pellarin

...on Financial Statement Shortcomings and Valuations

Among every business valuer's list of frustrating social moments is the time they are cornered in the lunch room, by the water cooler or (worst of all—because there's really no escape) in an elevator, has a financial statement handed to them, and hears the words...“so, what is this business worth?” While the question is usually followed by assertions along the lines of “just a rough estimate...honest, I won't hold you to it”, such momentary valuations¹ have a way of taking hold and, months later, they are the baseline against which subsequent business decisions (such as purchases and sales of shares) are measured.

For most successful businesses, valuation is premised on some indication of future cash flows. That is, what a purchaser will pay based on what they anticipate will be the cash flow stream that they will enjoy post-closing.

This article is an effort to explain why valuations based solely on financial statements do not work very well.

Cash flow

Cash flow, not earnings: The first problem is that financial statements, while including a statement of cash flows, are earnings-based. The basis of presentation is normally local GAAP or IFRS, and while those standards call for preparation of cash flow statements in most instances, their focus is really on the earnings statement (and to a lesser extent, the balance sheet). Earnings do not equate to cash flow, at least in the short run (although over a long period, the two do tend to coincide). The financial statements are, simply put, not a great device for measuring cash flow.

The future is now: Valuation of a business today is predicated upon what an investor thinks the cash flow will be tomorrow, not what it was yesterday. However, local GAAP or IFRS-based financial statements are, for the most part, focused on history. Their primary purpose is to tell us what happened, not to predict what will happen. That is not a bad thing; the study of history is a valid tool to help us move into the future. But to look at history, and assume the future will be the same (which is what someone is asking, when they value a business based on historic financial statements) is problematic.

In some (limited) areas, local GAAP or IFRS statements take a stab at disclosing future oriented financial information, by providing details such as future lease or debt repayment obligations. In some cases, future purchase/sale contracts are subject to “mark to market”

or similar measures, although even then, the disclosure can be insufficient for valuation purposes.

What is the entity: Although there are instances where the definition of “entity” is played with a bit (such as consolidations, combinations, proportionate consolidations, etc., where “entity” is broadened to include investees and related companies), for the most part, financial statements are prepared on an entity-by-entity basis. However, in many occurrences an entity encompasses several distinct businesses. They might operate as divisions, or they might be the same business, but operating in markets very distinct from each other (markets which the entity might enter and exit, without affecting the other markets). In these cases, the entity really consists of a number of businesses, and consideration should be given to valuing them separately. Financial statements do not provide sufficient information to allow for this. Even segmented reporting, when it is provided, is usually too “high level” for valuation purposes.

Non-arm's length transactions: Once we have defined the entity (or segment, or other unit of analysis) to be valued, and even if we are satisfied that its historic earnings provide some assistance in measuring future cash flows, those earnings must be “normalised” to restate them to the levels that would have been enjoyed, had the potential purchaser, rather than the present purchaser, owned the business. While financial statements begin to disclose related party transactions, they do not do so fully. For instance, the remuneration paid to related parties (such as shareholders/managers) is usually not disclosed. Also, even to the extent that related party transactions are disclosed, it is extremely rare that the statements would disclose any estimate of the fair value at which those transactions would have occurred, but for the relationship.

How about the balance sheet?

Who cares? There are times when the focus of the valuation is not the enterprise's cash flow, but its balance sheet. This might occur when the corporation's earnings are inadequate (and a liquidation basis is seen as appropriate), or when the business has assets of value which don't generate any earnings (such as a corporation which owns precious metals, non-income producing real estate, or any asset held primarily for capital appreciation). However, even in the more typical cases (where cash flow is the primary focus of the valuation), the valuer still performs a study of the balance sheet. Local GAAP or IFRS-based balance sheets present their own challenges.

¹ this article focuses on “fair market value”, but most of the concepts discussed have applicability in value-to-owner, fair value and many other valuation bases. It is beyond the scope of this article to discuss the differences between those valuation bases. Suffice to say that they are generally measures based on what someone would pay to have, or not have taken away, some promised future cash flow stream.

OK, so what are the challenges? Balance sheets are, for the most part, still presented on an historic cost basis. This shortcoming is most evident in the case of long-term assets, such as plant and equipment, the fair market value of which can differ from historic costs greatly. And intangible assets are generally not presented at all on financial statements, except when they are purchased (which is rare - they are usually self-generated), in which case they are generally carried at historic (or depreciated historic) cost, not fair market value.

Asset management: Another problem is that the financial statements (even absent of any of the above shortcomings) only tell the valuer what the assets are, not what they could or should have been. When assets are poorly managed, there are surpluses or deficiencies which translate to redundant assets and liabilities. The financial statements do not (and do not purport to) tell us how well the assets are managed, although they may give clues as to the existence of ill-managed assets (such as when bad debts are unusually high).

Anything else?

There are a number of areas relevant to business valuation which are simply not reflected in financial statements. Financial statements don't tell us much (if anything) about the business model itself - what does this entity sell? To whom is it sold? What is the value added? What are the barriers to entry in this industry and how susceptible is the business to competitors? Would this business benefit from a change in management? And how about the industry overall? Is the demand for its products growing and, if so, at what rate? These issues are generally not dealt with in financial statements except in unusual circumstances, such as when they factor negatively, and so negatively as to cast doubt on viability as a going concern.

So what good are they?

All of the above is not intended to say that financial statements are not meaningful for valuation. They remain probably the single most important piece of information in a business valuation. They are a road map or starting point that tells valuers where to drill down further.

Financial statements become increasingly relevant if change in the business is not likely. That is, if the industry is mature, if management is seen as viable and the business model is not in need of tweaking;

or if the valuation is to assist a purchaser who is only buying a minority position (and therefore will not have the ability to change management or create change, no matter how badly needed it might be). In these cases, to borrow an adage from human psychology, the best indicator of future behaviour is past behaviour and, therefore, the financial statements bear valuable information.

What else is required?

So, what other information is needed to answer the question 'how much is the business worth?' besides the financial statements?

A rudimentary list should include:

- industry and economic data, which reflect others' view of the industry, its constraints and risk
- business plans and projections of the business operations, including how they can be financed and banking agreements, which say a lot about others' view of the entity's risk
- detail of non-arm's length transactions, major existing contracts and working capital management

...and most importantly of all, access to management. Because in spite of our collective efforts to reduce the entire world to something that can be stored on a memory stick, there is no substitute for talking to real people.

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2 The point of view of ...



Christian Kampmeyer

...on Classification and measurement of financial assets - IFRS 9

Background

As already briefly indicated by Marco Mongiello in the news and update section of the March edition of RSM Reporting, IFRS 9 represents the first milestone in the comprehensive IASB project to replace IAS 39 Financial Instruments: Recognition and Measurement by mid 2011. Accounting for financial instruments is as complicated as several of the present day financial instruments themselves. The accounting provisions for financial assets in accordance with IAS 39 have been heavily criticised in the course of the recent global financial market crisis. In issuing IFRS 9 on 12 November 2009, the IASB aims to reduce the complexity in accounting for financial instruments by having fewer categories of financial assets and a principle-based approach to their classification.

IFRS 9 Financial Instruments completes the first part of a three phase project to replace IAS 39. The following two projects will deal with the categorisation of financial debts (ED already issued), the determination of amortised costs and impairments (ED already issued) and hedge accounting. The new standard addresses the classification and measurement of financial assets. It applies to all financial assets referred to by IAS 39.

While the mandatory date for adopting IFRS 9 is 1 January 2013, early adoption of phase 1 (IFRS 9) is permitted for reporting periods ending December 2009, if the regulating authorities allow it. However, the European Union (EU) has decided that no company within the EU should adopt the new accounting standard until the whole standard is out, so that the EU by the EFRAG respectively can evaluate the standard as a whole beforehand.

The following article will briefly present the main requirements contained in IFRS 9 and discuss several aspects and possible problems of its application. Emphasis will be put on the categorisation of financial assets.

IFRS 9 is intended to facilitate accounting for financial assets as requested by many constituents and stakeholders.

Initial recognition of financial assets

Unchanged from IAS 39, which is currently still in place, a company has to recognise a financial asset at the time it becomes party to the contractual provisions of the instrument.

At the same time, and this is different from IAS 39, the financial asset has to be allocated to either the category at amortised cost (herein after referred to as AC) or at fair value (herein after referred to as FV). This means that the former categories of IAS 39 Available for Sale, Held to Maturity, and Loans and Receivables are eliminated.

Classification groups

IFRS 9 uses a simple approach to determine whether a financial asset is measured at AC or FV.

Measured at amortised cost

The assessment of the new measurement approach is based on:

- how a company manages its financial instruments (its business model);

and

- the contractual cash flow characteristics of the financial assets.

IFRS 9 requires a financial asset to be classified at AC if:

- the objective of the company's business model is to hold the financial assets to collect the contractual cash flows;

and

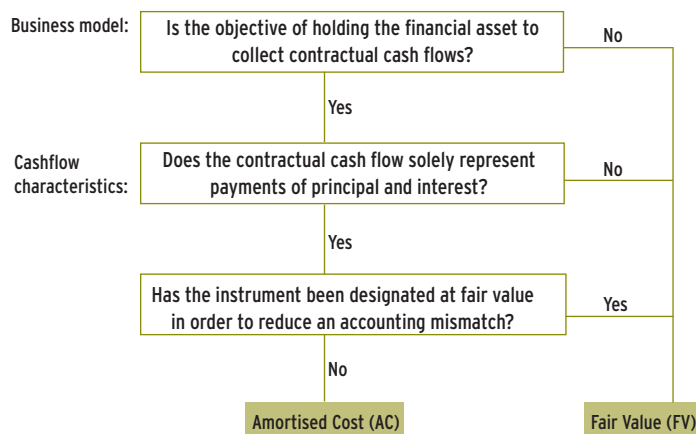
- the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding.

Where these two requirements are not met, the financial asset has to be measured at FV.

As a result of the new classification model, the only financial assets subject to impairment will be instruments measured at AC and all impairments are eligible for reversal.

The top-down decision tree for applying the new categories is depicted in Figure 1. Generally, the interest referred to above only represents payments for the time value of money and credit risk.

Figure 1



Measured at FV

An asset is classified as measured at FV if it is not classified as measured at AC given the rules above or if it has been designated at FV using the fair value option.

This option is a modified version of IAS 39's fair value option - the option to designate a financial asset at fair value through profit or loss under some circumstances.

For financial assets held at FV, all gains and losses are presented in profit or loss except for investments in equity, for which an entity can elect to present gains and losses in other comprehensive income (OCI) or in profit and loss.

Figure 2 below summarises the changes of measurement from IAS 39 to IFRS 9 for selected financial assets.

Figure 2

Instrument	Treatment according to IAS 39	Treatment according to IFRS 9
Debt instrument quoted in an active market, which is not held for trading according to the company's business model	FV (either through profit or loss or OCI) unless the entity has the positive intention and ability to hold to maturity	AC accounting warranted
Debt instruments classified as AFS under IAS 39, which are not in line with IFRS 9's AC measurement requirements	FV through OCI	FV through profit or loss
Asset backed securities where the terms of the loan give rise to cash flows other than payments of principal and interest or limit those cash flows in a way that is inconsistent with payments representing principal and interest	AC or FV (either through profit or loss or OCI)	FV through profit or loss
Investments in equity instruments which do not have a quoted market price and where FV cannot be reliably measured	Cost	FV*

* see section 6 of this article for further details

Decision tree criteria

The decision tree illustrated in Figure 1 requires the evaluation of three criteria in order to decide whether a financial asset is accounted for at AC or at FV.

Business model criterion (first criterion in decision tree under Fig. 1)

The IASB did not provide a clear and generic definition, leaving space for interpretation of practitioners during the application.

Instead, it merely states in the standard that an entity's business model for managing financial assets:

- is determined by the company's key management personnel (as defined in IAS 24 Related Party Disclosures); and
- does not depend on management's intentions for individual instruments.

Financial assets are not assessed on an individual instrument basis; instead classification is assessed at a higher level of aggregation on the basis of the entity's overall business model. IFRS 9 acknowledges that an entity may have separate business models for portfolios of investments that are managed in different ways (for example, an entity may hold one portfolio of investments which are managed in order to collect cash flows and hold another portfolio of investments which are managed in order to trade to realise fair value changes).

Cash flow characteristics criterion (second criterion in decision tree under Fig. 1)

A financial asset within a qualifying business model will be eligible for amortised cost accounting if 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.

Notwithstanding the necessary case-by-case assessment, standard debt instruments such as trade receivables, instalment credits and construction financing will undoubtedly satisfy the AC requirements.

No accounting mismatch (third criterion in decision tree under Fig. 1)

Management may still designate a financial asset at FV through profit and loss on initial recognition if this eliminated or significantly reduces recognition or measurement inconsistency, commonly referred to as accounting mismatch. This criterion will presumably only apply to rare cases.

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Gains and losses

For instruments accounted for at FV - gains and losses are recognised in profit or loss unless the equity instrument exemption (see section 6 below) applies.

For instruments accounted for at AC - movements in AC are recognised in line with the old IAS 39 rules.

Investments in equity instruments

Equity instruments do not demonstrate contractual cash flow characteristics of principal and interest; they are therefore accounted for at FV. IFRS 9 provides an option to designate a non-trading equity instrument either at FV through profit and loss or at FV through other comprehensive income. The designation is available on an instrument-by-instrument basis and only on initial recognition. Once made, the designation is irrevocable. All realised and unrealised fair value gains and losses follow the initial designation, and there is no recycling of fair value gains and losses recognised in other comprehensive income to profit and loss when finally realised. Dividends that represent a return on investment from equity investments will continue to be recognised in profit and loss regardless of the designation.

The exemption that existed in IAS 39 not to use FV for unquoted equity instruments where FV could not be reliably measured has been removed, which represents a significant change for a lot of IFRS adopters. However, in certain circumstances, cost may be an appropriate estimate of fair value, particularly in the event that only insufficient recent information for a fair value computation is available. But this exemption should be limited to rare cases.

Conclusion

The concentration on only two measurement categories will help to reduce the complexity. IFRS 9 also represents a significant move away from the rules-based standard of IAS 39 to a more principles-based standard. But some aspects give rise to criticism. Based on the classification criteria only debt instruments can be measured at AC, whereas equity instruments are always recorded at FV.

There will be discussion about the meaning of the term business model. The interpretation of this aspect will play a vital role in the accounting for financial assets. Unfortunately, the IASB has not provided a generic definition and this may irritate and confuse the users in the course of the implementation process.

On the one hand, the fact that IFRS 9 requires a retrospective application does bring an extensive workload but, on the other hand, the comparability of the annual reports will outweigh this drawback.

Along with the new standard, effects on other IFRSs have to be considered, such as more detailed disclosure requirements.

Since the three phase project is still running it is preferable that the IASB takes initiative to clarify some of its criteria, terms and meanings and outlines clearly requirements for additional disclosure and notes.

Despite the simplification deriving from the new upcoming standards of which IFRS 9 is the first one, which is desperately required considering the difficulties analysts and IFRS adopters face regarding the current IAS 39 and the pressure politics places on the standard setter, the implementation needs considerable efforts regarding the analysis and the transformation from the old IAS 39 to IFRS 9 and the accompanying standards to come.

The implementation of IFRS 9 will require a detailed stocktake of financial instruments and how they are treated at present and how they will be treated in the future. It will also require staff training on the changes, an analysis of current processes to account for financial instruments and a decision as to how to use scope of discretion with respect to accounting estimates (for example, the company's business model) and accounting options (consideration of fair value changes of equity instruments through P&L or OCI).

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Top Ten Topics in IFRS

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Top Ten Topics

1. Impairment ✓
2. Fair value measurement
3. Derecognition of financial instruments and Consolidation of Special Purpose Entities ✓
4. Purchase price allocation and Intangible assets ✓
5. Debt vs. Equity ✓
6. Hedging
7. Deferred tax
8. Revenue recognition
9. Employee benefits
10. First-time adoption of IFRS ✓

Joelle Moughanni

First time adoption of IFRS



Transition to IFRSs is a vast topic...summarising it in one article is an impossible mission! Therefore, first-time adoption of IFRSs is split in two parts: part one provides a practical overview of the main requirements of IFRS 1, while part two (in the next issue of RSM Reporting) will focus on key implementation issues of the exceptions and exemptions from IFRS 1's general principle of retrospective application of IFRSs.

What is the background to IFRS 1?

The spotlight first shone on IFRSs in 2001, when the European Commission announced that all entities listed on European stock exchanges would be required to adopt IFRSs by 2005. IFRSs are now in use for public reporting purposes in over 100 countries. In this context, the International Accounting Standards Board (IASB) first published IFRS 1 First-time Adoption of International Financial Reporting Standards in June 2003 in order to address concerns about the full retrospective application of IFRSs as required then by SIC-8 (costs exceeding benefits, impracticability, hindsight, etc.).

Subsequently, significant amendments have been made to IFRS 1, making it more complex and less clear. The current restructured version, substantially rewritten - without amending its substance though - is now a more user-friendly Standard¹.

When shall an entity apply IFRS 1?

Entities are required to apply IFRS 1 in their first IFRS financial statements and in each interim financial report, if any, prepared in accordance with IAS 34 Interim Financial Reporting for part of the period covered by those first IFRS financial statements.

For example, if an entity's first IFRS financial statements year-end is on 31/12/10 and if the entity chooses (or is required by local regulation, on a listed market, for example) to publish quarterly financial information in accordance with IAS 34, it must then apply IFRS 1 on 31/3/10, 30/6/10, 30/9/10 and 31/12/10. Any change in accounting policies during 2010 should be dealt with under IFRS 1 and not IAS 8.

Which financial statements are to be considered an entity's first IFRS financial statements?

An entity's first IFRS financial statements are the first annual financial statements prepared for external use in which the entity adopts IFRSs by including an explicit and unreserved statement of compliance

with IFRS. Thus, the scope of IFRS 1 is based on a simple, unique and objective test that gives an unambiguous answer: an entity adopts IFRSs if, and only if, its financial statements contain for the first time an explicit and unreserved statement of compliance with IFRSs.

In its 31/12/10 IFRSs compliant financial statements, is an entity considered a first-time adopter (i.e. in the scope of IFRS 1) in the following situations?

Situation	First-time adopter?	Rationale
The entity has always issued financial statements with an unreserved statement of compliance with IFRSs, except in its 31/12/09 financial statements, where the entity stated compliance with local GAAP only	Yes	The entity did not make an explicit and unreserved statement of compliance with IFRSs in its most immediately previous financial statements
The 31/12/09 financial statements were in conformity with IFRSs in all respects, except that they did not contain an explicit and unreserved statement of compliance with IFRSs	Yes	The explicit and unreserved statement of compliance with IFRSs criterion is not satisfied
The 31/12/09 financial statements contained an explicit and unreserved statement of compliance with IFRSs, but the auditor's report contained a qualification in this respect	No	The 2009 financial statements have already been considered IFRSs compliant and relied upon as such (any errors should be accounted for in accordance with IAS 8)

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¹ The restructured version of IFRS 1 was issued by the IASB on 27/11/08. It is effective for entities applying IFRSs for the first time for annual periods beginning on or after 1/7/09 with earlier application permitted.

3 Top Ten Topics in IFRS

Situation	First-time adopter?	Rationale
The 31/12/09 financial statements contained an explicit statement of compliance with IFRSs "except for IFRS 7"	Yes	Financial statements cannot be described as IFRSs compliant unless they comply with all the requirements of existing IFRS, IAS, SIC and IFRIC (recognition, measurement, presentation and disclosure)
The 31/12/09 financial statements contained an explicit statement of compliance with IFRSs "as endorsed by the EU"		
On 31/12/09, the entity prepared IFRSs compliant financial statements for its internal management only	Yes	The entity did not make them available to any external users
Same as above, however the entity made the internal IFRS financial statements available only to its banks	No	The extent of distribution is not a differentiating criterion
The 31/12/09 financial statements contained an explicit statement of compliance with IFRSs for SMEs	Yes	IFRSs for SMEs and full IFRSs are two separate and distinct frameworks

What is the general principle underlying the first IFRSs financial statements?

A first-time adopter is required to apply IFRSs that are effective at the date of its first IFRSs financial statements retrospectively in the opening IFRS statement of financial position, the comparative period and the first IFRS reporting period. In other words, if an entity adopts IFRSs for the year ended 31/12/10, it must apply all IFRSs effective at that date retrospectively to the 2010 and 2009 reporting periods, and to the opening statement of financial position on 1/1/09².

This general principle would result in full retrospective application of IFRSs, as if they have always been applied by the entity. However, a limited number of 'exceptions' (mandatory) and 'exemptions' (optional) to this 'retrospectivity' principle are available.

Practically, where to start?

The very starting point for the first-time adopter is to prepare an opening IFRS statement of financial position at the date of transition to IFRSs, that is the beginning of the earliest period for which the entity presents full comparative information under IFRSs (1/1/09 for first IFRSs financial statements on 31/12/10, considering presentation of one year of comparative information). Subject to a limited number of exceptions and exemptions, the retrospective application of IFRSs involves the following:

In the opening IFRS statement of financial position	Common Implications
Recognise all assets and liabilities that IFRSs require	<ul style="list-style-type: none"> Defined benefit pension plans (IAS 19) Deferred tax (IAS 12) Finance lease assets and liabilities (IAS 17) Legal or constructive provisions (IAS 37) Derivative financial instruments (IAS 39) Acquired intangible assets (IAS 38) Internal development costs (IAS 38) Share-based payments (IFRS 2)
Derecognise assets and liabilities that IFRSs do not permit	<ul style="list-style-type: none"> Provisions if no legal or constructive obligation (IAS 37) General reserves (IAS 37) Deferred tax assets if recovery not probable (IAS 12) Intangible assets not meeting criteria (IAS 38)
Re-classify assets and liabilities in accordance with IFRSs	<ul style="list-style-type: none"> Financial assets (IAS 39) Financial liabilities and equity (IAS 32) Offsetting (restricted under IFRSs) Intangible assets and goodwill (IAS 38 and IFRS 3) Treasury shares in equity (IAS 32)
Measure all assets and liabilities under IFRSs	<ul style="list-style-type: none"> Financial instruments (IAS 39) Employee benefit obligations (IAS 19) Provisions (IAS 37) Impairment of assets (IAS 36) Assets held for disposal (IFRS 5) Deferred tax (IAS 12)

² Under IFRS 1, an entity applies the latest version of IFRSs (without considering superseded or amended versions) and the transitional provisions of other IFRSs do not apply to a first-time adopter. In fact, IFRS 1 is comprehensive of all provisions relating to first-time adoption of IFRSs.

How are the adjustments arising on transition to IFRSs accounted for?

All adjustments arising on transition will usually be recognised in retained earnings, except in those cases where another Standard requires a separate component of equity to be recognised. For example, when an entity applies the revaluation model in IAS 16 Property, Plant and Equipment, the difference between fair value and depreciated cost at the date of transition will be credited to a revaluation reserve.

What if retrospective application of IFRSs cannot be performed with sufficient reliability?

In some situations, retrospective application of IFRSs involves a high degree of judgment by management using the benefit of hindsight. To counter this, a first-time adopter is prohibited from applying IFRSs retrospectively in the following areas (mandatory exceptions of IFRS 1):

- Accounting estimates
- Derecognition of financial assets and financial liabilities
- Hedge accounting
- Non-controlling interests

What if retrospective application of IFRSs is impracticable within a reasonable costs/benefit ratio?

A first-time adopter can elect to apply IFRSs prospectively in some specific areas (the optional exemptions list is given by IFRS 1) and each optional exemption is applied independently, i.e. an entity that elects to apply one of the exemptions in the list is not required to apply any (or all) of the other exemptions. However, beware of the possible interaction between some exceptions and exemptions, one of the most complex areas on transition! In determining which optional exemptions to apply, a first-time adopter should consider the effect not only on transition but also on ongoing reporting under IFRSs.

These are targeted exemptions for limited circumstances where retrospective restatement in accordance with IFRSs is not required. Therefore, they cannot be extended or applied by analogy to other areas.

Is an entity relieved from any presentation and disclosure requirements in its first IFRSs financial statements?

No. A first-time adopter must comply with the presentation and disclosure requirements of IAS 1 Presentation of Financial Statements and all other IFRSs plus additional requirements imposed by IFRS 1. Mainly, they should clearly reconcile and explain how the transition from their previous GAAP to IFRSs affected their previously reported financial position, financial performance and cash flows. A columnar presentation of those reconciliations and explanations is recommended for clarity purposes, as in the illustration below.

		As at 01/01/20X1 (date of transition)			As at 31/12/20X1 (end of last period presented under previous GAAP)		
CU million	Notes	Previous GAAP	Effect of transition to IFRS	Opening IFRS statement of financial position	Previous GAAP	Effect of transition to IFRS	IFRS
Property, plant and equipment		75,973	-	75,973	96,680	-	96,680
Goodwill	f	1,567	-	1,567	5,504	730	6,234
Intangible assets	a	200	2,056	2,256	943	2,458	3,401
Financial assets	j	2,680	36	2,716	4,065	16	4,081
Total non-current assets		80,420	2,092	82,512	107,192	3,204	110,396

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