

The impacts of new and proposed accounting rules

What is the issue?

The International Accounting Standards Board's (IASB's) work plan for the next three years includes approximately 30 new IFRS projects. Nearly all standards will be reworked to some extent, with potentially significant strategic and operational implications for entities. This edition of *IFRS in brief* addresses the impacts of these changes on business; particularly the finance teams and audit committee.

Impact on profit and loss	✓
Impact on balance sheet	✓
Impact on disclosures	✓
Impact on stakeholder communication	✓

Why this avalanche of new accounting standards in 2010, 2011 and 2012?

There are several reasons for the IASB's ambitious workload.

- **Pressure from the Group of 20.** Amid the financial crisis, the G20 asked the IASB to improve transparency in respect of entities' financial risks (through revised consolidation rules), limit the pro-cyclical effects of certain standards (some believe the impairment and fair value requirements contributed to market turmoil) and fast track several important projects (for example, making financial statements easier to understand).
- **Continued efforts to converge IFRS and US GAAP.** The IASB is planning changes to the accounting for joint ventures, leases, revenue and pension liabilities, to help achieve convergence. Another area of scrutiny is the rules for classification of complex financial instruments as debt or equity.
- **Develop new rules and improve existing rules.** The IASB is focusing on dealing with new accounting issues (for example, accounting for greenhouse gas emissions and activities with regulated tariffs) and addressing issues in practice (for example, improving standards dealing with debt and provisions).

How might the upcoming accounting changes increase some groups' liabilities?

Some of the proposed IFRS revisions are likely to require the recognition of additional liabilities in the balance sheet - in particular, in the areas of leases and tax accounting.

- Obligations arising from all lease contracts (not only finance leases) would be reported on the balance sheet under the proposed changes to accounting for leases. The amount recognised would include not only rental payments over the term of the contract, but also other items like purchase options, rental payments over probable renewal periods, contingent rental payments and residual value guarantees.
- The proposed revised 'basic ownership' criteria for the classification of financial instruments as equity would lead to a narrower view of equity, which would result in more instruments being classified as liabilities.

The impacts of new and proposed accounting rules...cont'd

How might upcoming accounting changes impact the recognition of revenue?

Proposed changes may delay the timing of when revenue is recognised.

- Revenue from some long-term contracts may need to be recognised at each stage that the contract is performed (and no longer based on the percentage of completion method).
- The recognition of revenue from warranties associated with the sale of goods may be delayed until the end of the warranty period (instead of being recognised at the time of sale).
- The expected (rather than incurred) loss approach to impairment of receivables would result in reduced interest revenue earlier in the collection period.

How might upcoming accounting changes affect earnings volatility?

More financial statement volatility is expected in coming years.

- The revised IFRS 3, 'Business combinations' (effective from 1 July 2009), impacts earnings in the year of a transaction and for several years afterwards. For example, gaining control over a subsidiary via a step acquisition triggers the recognition of a gain or loss on the previously held interest. Any changes to earn-out estimates and deferred tax assets after the initial 12 months will need to be recognised in the income statement (not in goodwill).
- Comprehensive income is the new 'bottom line' of the income statement under the revised IAS 1, 'Financial statement presentation' (effective from 1 January 2010). This presentation change may fuel volatility in relation to the items added to net profit/loss to derive comprehensive income (for example, translation differences, unrealised gains and losses on securities, and hedges).
- An increased number of financial instruments will be measured at fair value under IFRS 9, 'Financial instruments', which will consequently lead to more volatility in reported earnings. For example, complex debt instruments will be recognised at fair value through profit and loss rather than amortised cost.

How might upcoming accounting changes may affect performance ratios?

Entities' profitability indicators may be affected by changes in certain accounting treatments. For example, the proposed changes to accounting for leases and provisions may affect gross profit, earnings before interest, taxes, depreciation and amortisation (EBITDA) and operating profit.

What do I need to do now?

- **The new business combination rules apply to 2010 accounts.** Entities planning an acquisition should consider the effect of the new rules before finalising a deal. Some of the questions to consider include: how should the contingent consideration be structured (for example, debt or equity)?; are the terms of the contingent consideration such that it will be accounted for as consideration in the acquisition or as remuneration (for example, to selling shareholders); will there be earnings volatility arising from the transaction or balance sheet impacts that should be considered to avoid breaching banking covenants?
- **Proposed changes to accounting for leases.** Entities that are contemplating extending their existing lease arrangements, expecting to enter into new lease arrangements, or that are in the process of making their 'lease versus buy' decisions should be mindful of the proposed changes and the likely impact on their business and future results.
- **Proposed changes to the recognition of revenue.** Entities should consider whether they need to clarify the terms or conditions of their contracts with customers. This is particularly the case for entities that enter into contracts with multiple elements, such as where goods and services are sold together but delivered at different times, and those entities that engage in longer term projects in the construction industry (that is, projects that span more than one accounting period).