

SELF-STUDY CONTINUING PROFESSIONAL EDUCATION

The Globalization of Accounting: IFRS versus GAAP

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The Globalization of Accounting: IFRS versus GAAP (IFRTG10)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course discusses the nature and role of the IASB and the IASC and their respective pronouncements. It includes the most recent IFRS, presenting a summary of the IFRS and a comparison of each IFRS with GAAP.
PUBLICATION/REVISION DATE:	July 2010
PREREQUISITE/ADVANCE PREPARATION:	Basic knowledge of GAAP
CPE CREDIT:	8 QAS Hours, 8 Registry Hours Check with the state board of accountancy in the state in which you are licensed to determine if they participate in the QAS program and allow QAS CPE credit hours. This course is based on one CPE credit for each 50 minutes of study time in accordance with standards issued by NASBA. Note that some states require 100-minute contact hours for self-study. You may also visit the NASBA website at www.nasba.org for a listing of states that accept QAS hours.
FIELD OF STUDY:	Accounting
EXPIRATION DATE:	July 31, 2011
KNOWLEDGE LEVEL:	Basic

LEARNING OBJECTIVES

Chapter 1: Evolution of the Standard-setting Issue

Completion of this chapter will enable you to:

- Identify how the standard-setting issue evolved in the U.S.
- Discuss the evolution of standard-setting in countries outside the U.S.

Chapter 2: Financial Statement Presentation

Completion of this chapter will enable you to:

- Identify the basic requirements of IFRS-based financial statements.
- Differentiate between U.S. GAAP financial statements and IFRS-based financial statements.

Chapter 3: Property, Plant and Equipment, and Lease Accounting

Completion of this chapter will enable you to:

- Explain the cost used in IFRS and U.S. GAAP for valuing property, plant and equipment, and optional revaluation model used in IFRS.
- Differentiate between types of leases and how to account for the leases under IFRS and U.S. GAAP.

Chapter 4: Intangible Assets, Impairments, Non-current Assets Held for Sale and Discontinued Operations

Completion of this chapter will enable you to:

- Describe the differences between U.S. GAAP and IFRS in the accounting for various intangible assets and contrast impairment tests under both standards.
- Discuss the differences in reporting discontinued operations between U.S. GAAP and IFRS.

Chapter 5: Accounting for Income Taxes and Share-Based Payments

Completion of this chapter will enable you to:

- Identify the positions taken by the IASB with respect to accounting for income taxes and contrast the positions taken by the IASB with those taken by the FASB.
- Identify the positions taken by the IASB with respect to share-based payments and contrast the positions taken by the IASB with those taken by the FASB.

Chapter 6: Business Combinations and Consolidated Financial Statements

Completion of this chapter will enable you to:

- Identify the positions taken by the IASB with respect to business combinations and contrast them with those of the FASB.
- Identify the positions taken by the IASB regarding consolidated financial statements and contrast them with those of the FASB.

Chapter 7: Provisions, Contingencies, Revenue Recognition and Miscellaneous Topics

Completion of this chapter will enable you to:

- Distinguish between a provision and a contingent liability under IFRS and summarize the differences under U.S. GAAP.
- Identify the differences in accounting for contracts, application of lower of cost or market inventory valuation and “events after the balance sheet date” under U.S. GAAP and IFRS.

Chapter 8: Financial Instruments and First-Time Adoption of IFRS

Completion of this chapter will enable you to:

- Identify the positions taken by the IASB and contrast with the positions taken by the FASB with respect to financial instruments.
- List the requirements for an entity’s first-time adoption of IFRS.

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Chapter 1: Evolution of the Standard-setting Issue

Introduction

This chapter introduces the issue of IFRS versus U.S. GAAP and discusses how the standard-setting issue evolved, and the significant differences between International Financial Reporting Standards (IFRS) and U.S. GAAP. It does not discuss every possible difference; rather, it is a summary of what the authors consider to be most relevant differences for the majority of the users of this course. The principal focus is on the differences related to recognition, measurement and presentation, rather than on disclosure.

Learning Objectives

Completion of this chapter will enable you to:

- Identify how the standard-setting issue evolved in the U.S.
- Discuss the evolution of standard-setting in countries outside the U.S.

Terms and Acronyms Used in the Course Regarding the IASB and the FASB

U.S. GAAP refers to generally accepted accounting principles as recognized or required by the Financial Accounting Standards Board (FASB). SFAS 162, *The Hierarchy of Generally Accepted Accounting Principles*, currently specifies the GAAP hierarchy. However, the FASB has issued an exposure draft, *The Hierarchy of Generally Accepted Accounting Principles*, that would replace SFAS 162 effective July 1, 2009, and specifies that there will be two levels of U.S. GAAP—authoritative and nonauthoritative. The authoritative GAAP would be the *FASB Accounting Standards Codification*. However, authoritative GAAP for SEC registrants also would include the rules and interpretive releases of the SEC.

The International Accounting Standards Board (IASB) publishes its standards in a series of pronouncements called International Financial Reporting Standards (IFRSs). When it was initially formed, the IASB adopted the International Accounting Standards (IASs) issued by its predecessor, the International Accounting Standards Committee (IASC). The term “International Financial Reporting Standards” includes IFRSs, IASs and Interpretations originated by the International Financial Reporting Interpretations Committee (IFRIC) or its predecessor, the Standards Interpretations Committee (SIC). In this course, except when it refers to a specific IFRS (e.g. IFRS 7), the description “IFRS” will include all IFRSs, IASs, IFRICs and SICs.

Introduction to the Evolution of Standard Setting in the U.S.

The evolution of the standard-setting issue has been influenced by many things, people, and organizations. As a subset of a social science, accounting is one of those fields in which the winner is decided by a “vote.” That is, who sets standards and what those standards are is a matter of a “vote” of those that have the power to vote on such matters.

Oftentimes, in a social science, the standard-setter is identified as a result of some major chaos inside the social science. In the United States, there were no recognized accounting standards prior to the 1930s. The stock market crash of 1929 and the attendant world-wide economic collapse around that time led to chaos in the securities markets. Congress reacted to the chaos by enacting the Securities Act of 1933 and the Securities and Exchange Act of

1934. The private sector (the American Institute of Accountants (AIA), which in 1957 became the AICPA) responded by engaging in formal discussions with the New York Stock Exchange. In addition, the AIA established the first formal standard-setting body in the U.S., the Committee on Accounting Procedure.

Committee on Accounting Procedure

The Committee on Accounting Procedure (CAP), a committee of the AIA, became operational in 1938. It issued Accounting Research Bulletins (ARB) 1-42, and then issued ARB 43 and Accounting Terminology Bulletin 1 as a codification of the first 42 ARBs that were still in effect. It had been an ad hoc committee of the Institute prior to the Institute's establishment of it as "the" standard-setting body. CAP later issued ARBs 44-51 before being replaced in 1959 by the Accounting Principles Board (APB).

CAP decided that it would not seek to develop a comprehensive statement of accounting principles or a conceptual framework. Instead, it followed a "brush-fire" approach in dealing with specific accounting problems. This approach led to a lack of consistency among the ARBs.

The ARBs represented the considered opinion of at least two-thirds of all CAP members. The authority of the ARBs rested on their "general acceptability." They were not formally recognized by the SEC.

Accounting Principles Board

The leadership of the AICPA decided that CAP should be replaced by the Accounting Principles Board (APB). One of the major differences between CAP and the APB was to be the establishment of a more formal research division, the Accounting Research Division, within the AICPA to assist the APB. The Accounting Research Division was to study and research the important issues related to financial accounting and reporting and prepare Accounting Research Studies to assist the APB and to educate practitioners and users of financial statements about the various financial accounting and reporting issues. Two of the first three Accounting Research Studies issued by the Accounting Research Division addressed accounting principles from a broader perspective rather than from a perspective of dealing with a specific accounting problem. These two Accounting Research Studies (ARS) were ARS No. 1, *The Basic Postulates of Accounting*, and ARS No. 3, *A Tentative Set of Broad Accounting Principles for Business Enterprises*. Unfortunately these two ARSs were not well received by a number of members of the APB who were practicing accountants. Some APB members even deemed the recommendations of those two research studies to be too "radical." (Interestingly, many, if not most, of the accounting and reporting recommendations included in those studies are now a part of accepted practice. An example is the use of fair value to measure marketable securities.) Like the CAP, the APB chose not to establish a more formal conceptual framework. The net effect of the APB's reaction to the ARS Nos. 1 and 3 and its decision not to establish a conceptual framework was that, from a substantive standpoint, the APB was no different than the CAP.

Authoritativeness of APB Opinions

The APB was the chief standard setter during the years 1959-1973, being replaced in 1973 by the FASB. Its most authoritative pronouncements were APB Opinions. It also issued APB Statements, which were not as authoritative.

The authoritativeness of the first five APB Opinions was the same as the ARBs issued by the CAP. Their authority rested on their “general acceptability.” The APB attached an addendum to APB Opinion No. 6 which included a special bulletin from Council of the AICPA that attempted to make the APB Opinions more authoritative. The special bulletin attempted to require that, as a minimum, departures from the APB Opinions would have to be disclosed. However, legal counsel of the Institute determined that the requirement reflected in the special bulletin was not enforceable because it was not in the Institute’s by-laws.

The authoritativeness of the APB Opinions did not change until the AICPA issued Rule 203 of its *Rules of Professional Conduct*. Rule 203 prohibited a member from expressing his or her opinion that financial statements are presented in conformity with GAAP if the statements contain a material departure from pronouncements issued by the APB. The only exception is that if such conformity would cause the financial statements to be misleading, in which case the AICPA member has to describe the departure and the reasons why compliance would result in the financial statements being misleading. The first APB Opinion issued after Rule 203 was APB Opinion No. 28. APB Opinion No. 31 was the last APB Opinion issued by the APB.

Financial Accounting Standards Board

The AICPA formed two committees in the early 1970s to help improve financial accounting standards and the standard-setting process. The Trueblood Committee addressed the issue of objectives of financial reporting and the Wheat Committee addressed the standard-setting process.

The Wheat Committee recommended the establishment of a new standard-setting body independent of the AICPA. That body became known as the Financial Accounting Standards Board. The members were to be appointed by the Financial Accounting Foundation, which was established to appoint FASB members and assist the FASB in administrative and fund-raising matters.

Reasons the FASB Was Expected to Improve Standard Setting

There were several reasons why the FASB was expected to be an improvement over its predecessors. Some of the principal reasons were:

- Full-time members
- Smaller number of members
- Independence of members
- Explicit recognition by the SEC
- Formal recognition by the AICPA
- Effort to establish a conceptual framework

Full-time Members. The fact that the members of the FASB were to be full-time members was expected to improve standard setting by allowing the members to devote their full attention to standard setting. The part-time members of CAP and the APB had significant responsibilities to other entities, such as accounting firms, companies, and other types of organizations.

Smaller Number of Members. Initially, the FASB consisted of seven full-time members (reduced to five members in 2008). Many believed that the larger number of members of CAP and APB made the standard-setting process more cumbersome and less efficient. It was expected that the smaller number of members would allow the Board to get more done in less time.

Independence of Members. The members of the FASB were required to sever their ties with any firms, companies, or other organizations by whom they were previously employed. The fact that members of the predecessor boards were on the payroll of other organizations presented a problem from the standpoint of the appearance of a lack of independence; those voting on standards were in the employ of entities perhaps directly affected by those standards.

Explicit Recognition by the SEC. Neither the CAP nor the APB was granted explicit recognition by the SEC. The SEC implicitly recognized the private-sector standard-setting body in its Accounting Series Release (ASR) 4, issued in 1938. In ASR 4, the SEC stated: "In cases where financial statements filed with the Commission pursuant to its rules and regulations under the Securities Act or the Exchange Act are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material." **(ASR 4)** While the SEC emphasized in ASR 4 that accounting principles must have substantial authoritative support, it did not describe how substantial authoritative support was to be determined. It also made no specific reference to any particular standard-setting body and did not indicate that SEC registrants had to follow the pronouncements of any particular body or organization. At that time, the only standard-setting body was a special ad-hoc committee on accounting procedure of the AIA, the (CAP). In 1938, the ad-hoc committee, CAP, was expanded and authorized by the Institute to issue pronouncements related to accounting principles. However, after the establishment of the CAP, there was no later recognition by the SEC in an ASR of the CAP. There also was no formal recognition later of any requirement of SEC registrants to follow pronouncements of the APB.

The SEC formally recognized the FASB in ASR 150 in 1973, the year in which the FASB became operational. In ASR 150, the SEC explicitly stated that "the body designated ...to establish accounting principles is the Financial Accounting Standards Board...." Further, the SEC stated in ASR 150: "For purposes of this policy, principles, standards, and practices promulgated by the FASB in its Statements and Interpretations will be considered by the Commission as having substantial authoritative support, and those contrary to such FASB promulgations will be considered to have no such support." **(ASR 150)** Thus, the SEC explicitly recognized the authoritativeness of the FASB, whereas it had not done so with respect to its predecessor private sector standard-setting bodies (CAP and APB).

The SEC also formally recognized the authoritativeness of the FASB in SEC Release No. 33-8221 (April 25, 2003) issued in response to the requirements of section 108 of the Sarbanes-Oxley Act of 2002. Release No. 33-8221 updated ASR 150 and indicated the SEC's continued intent to continue to look to the private sector for leadership in establishing and improving accounting standards.

Formal Recognition by the AIA/AICPA. The CAP was a committee of the AIA/AICPA. However, there were no by-laws that required members to follow the pronouncements of the CAP. Thus, the authoritativeness of the ARBs depended on their general acceptability. Initially, the same could be said for the pronouncements of the APB. However, in 1964 Council of the AICPA issued an “edict” in which it attempted to require members of the AICPA to adhere to the pronouncements of the APB. This “edict” also was presented as an appendix to APB Opinion No. 6. Legal counsel of the Institute pointed out that this “edict” was not enforceable because this requirement was not included in the Institute’s By-Laws or Rules of Professional Conduct. Thus, there still was not an enforceable requirement for the members of the AICPA to follow the pronouncements of the APB. However, in 1973, the AICPA enacted Rule 203 as a part of its *Code of Professional Conduct* that prevented members of the AICPA from being associated with financial statements that were not in accord with the pronouncements of the APB unless compliance with the pronouncements of the APB would cause the financial statements to be materially misleading. In the latter case, the member had to disclose such departure from the APB’s pronouncements and why such conformance would cause the financial statements to be misleading.

Establishment of a Conceptual Framework. One of the salient differences between the FASB and its two predecessors was its attempt to establish a conceptual framework. The failure to do so on the part of the CAP and the APB over time contributed to the inconsistencies of those two standard-setting bodies’ pronouncements. For example, an asset had not been formally defined prior to the issuance of any ARBs or APB Opinions. The FASB’s conceptual framework helped establish a certain level of consistency among the FASB’s pronouncements. To date, the FASB has issued seven formal Statements of Financial Accounting Concepts that are a direct result of the FASB’s conceptual framework.

Role and Impact of the SEC

The SEC was established in 1934 to administer the Securities Act of 1933 and the Exchange Act of 1934. It is comprised of five SEC commissioners. Early in its existence, the SEC voted by a 3-2 vote to have accounting standards established in the private sector. However, the SEC did not give up the right to override the private-sector standard-setting body. Since that time, the SEC has overruled the private-sector standard-setting body on a small number of occasions.

The SEC implicitly recognized the private-sector standard-setting body in its Accounting Series Release (ASR) 4, issued in 1938. In ASR 4, the SEC stated: “In cases where financial statements filed with the Commission pursuant to its rules and regulations under the Securities Act or the Exchange Act are prepared in accordance with accounting principles for which there is no substantial authoritative support, such financial statements will be presumed to be misleading or inaccurate despite disclosures contained in the certificate of the accountant or in footnotes to the statements provided the matters involved are material.” **(ASR 4)**

The SEC first formally recognized a private-sector standard-setting body in ASR 150 in which it stated that “the body presently designated ... to establish accounting principles is the Financial Accounting Standards Board....” **(ASR 150)** Generally, the SEC has looked to the private-sector standard-setting body for the establishment of accounting standards. Rarely has the SEC overridden the FASB with regard to the FASB’s published accounting pronouncements.

SEC Release No. 33-8221

The Sarbanes-Oxley Act of 2002 required the SEC to acknowledge which private-sector standard-setting body has the power to establish accounting standards for the U.S. In Release No. 33-8221, the SEC specified that the FASB is that standard-setting body.

SEC Release No. 33-8879—Requirements for Foreign Entities

Historically, entities domiciled outside the U.S. that have chosen to use U.S. securities markets have been required to reconcile their non-U.S. GAAP financial statements to U.S. GAAP. However, on December 31, 2007, the SEC issued Release 33-8879 that allows foreign private issuers to file financial statements with the SEC without reconciliation to U.S. GAAP if those statements are prepared in accordance with IFRS as issued by the IASB. Release 33-8879 became effective March 4, 2008 for financial statements for years ending after November 15, 2007.

The term *foreign private issuer* is defined in Exchange Act Rule 3b-4(c) as “any foreign issuer other than a foreign government except an issuer that meets the following conditions: (1) more than 50 percent of the issuer’s outstanding voting securities are directly or indirectly held of record by residents of the United States; and (2) any of the following: (i) the majority of the executive officers or directors are United States citizens or residents; (ii) more than 50 percent of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.”

It is important to note that Release 33-8879 only applies to financial statements prepared in accordance with IFRS as issued by the IASB. Thus, it would not apply to the financial statements prepared in accordance with any other country’s GAAP or to financial statements prepared in accordance with IFRS if a country has modified IFRS for purposes of that particular country. Some countries start with the basic IFRS and modify them to fit their particular situation. It would be the equivalent of the U.S. starting with IFRS and modifying certain parts, for example, the requirement that LIFO cannot be used.

One should also note that Release 33-8879 allows but does not require the use of IFRS. Thus, a foreign private issuer initially could choose to use IFRS or to reconcile to U.S. GAAP. Currently, a U.S.-based company does not have that choice; it is required to use U.S. GAAP.

SEC Release No. 33-8831

The SEC issued Concept Release 33-8831 on August 7, 2007 “to obtain information about the extent and nature of the public’s interest in allowing U.S. issuers...to prepare financial statements in accordance with International Financial Reporting Standards as published by the International Accounting Standards Board...” Note that this Concept Release was for the purpose of obtaining feedback and did not serve as a proposed position of the SEC. Nevertheless, it certainly was significant in indicating that the SEC would even consider such a move.

The SEC Roadmap

Recent Developments—SEC Release Nos. 33-9109; 34-61578

On February 23, 2010, the SEC reaffirmed its commitment to the convergence of U.S. GAAP and IFRS.

After consideration of comment letters received, the Commission directed the staff to develop a Work Plan, the results of which will aid the Commission in evaluating the effect of IFRS on financial reporting by U.S. companies. The Work Plan will address six areas of concern:

- Sufficient development and application of IFRS for the U.S. domestic reporting system
- The independence of standard setting for the benefit of investors
- Investor understanding and education regarding IFRS
- Examination of the U.S. regulatory environment that would be affected by a change in accounting standards
- The impact on issuers, both large and small, including changes to accounting systems, changes to contractual arrangements, corporate governance considerations, and litigation contingencies
- Human capital readiness

Public progress reports on the Work Plan will be available beginning in October 2010. By 2011, the Commission will decide whether to incorporate IFRS into the U.S. financial reporting system, and if so, when and how. If the Commission determines in 2011 to incorporate IFRS into the U.S. financial reporting system, the first time U.S. companies would report under such a system would be no earlier than 2015.

The SEC has withdrawn the proposed rules to allow early adoption of IFRS and is not currently pursuing an early use option. Also, they are not ruling out the possibility of permitting issuers to choose between IFRS and GAAP.

SEC Release No. 33-8982, Proposed Rule: *Roadmap for the Potential Use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*

On November 14, 2008, the SEC issued Release 33-8982, *Roadmap for the Potential use of Financial Statements Prepared in Accordance with International Financial Reporting Standards by U.S. Issuers*. The SEC stated that “this Roadmap sets forth several milestones that, if achieved, could lead to the required use of IFRS by U.S. issuers in 2014 if the Commission believes it to be in the public interest and for the protection of investors.” The SEC also is proposing to allow early use of IFRS by a limited number of U.S. issuers if the issuer’s industry uses IFRS as the basis of financial reporting more than any other set of standards.

Under the Release, the SEC in 2011 will determine whether to proceed with rulemaking to require U.S. issuers to use IFRS beginning in 2014.

The Milestones

The milestones identified in Release 33-8982 relate to:

- Improvements in accounting standards;
- Accountability and funding of the IASC Foundation;
- Improvement in the ability to use interactive data for IFRS reporting;
- Education and training relating to IFRS;
- Limited early use of IFRS where this would enhance comparability for U.S. investors;
- Anticipated timing of future rulemaking by the Commission; and
- Implementation of the mandatory use of IFRS by U.S. issuers.

Milestone—Improvement in Accounting Standards

In 2002, the FASB and the IASB announced the issuance of a memorandum of understanding, called the Norwalk Agreement. The two Boards agreed to strive for high-quality, compatible accounting standards that could be used for domestic and cross-border financial reporting. The two Boards also pledged to try to make their existing financial reporting standards fully compatible as soon as practicable.

Later, in a 2006 Memorandum of Understanding, the FASB and the IASB “indicated that a common set of high-quality global standards remains the long-term strategic priority of both the FASB and the IASB.” The two Boards established a convergence project that would entail both Boards taking up certain projects at the same time, and perhaps jointly. The convergence project covered specific short-term and long-term projects for convergence work through 2008. The two Boards later updated this timetable for their joint work resulting in a joint work plan that goes through 2011.

The SEC also has noted in previous years areas where IFRS provide limited guidance on a particular topic, such as accounting for insurance contracts and extractive activities.

Thus, in assessing whether this milestone is being achieved, the SEC will assess whether it believes that the FASB and the IASB have made sufficient progress under the Norwalk Agreement and whether it believes that the IASB continues to develop its standards, including converged standards, through an acceptable process.

Milestone—Accountability and Funding of IASC Foundation

Funding. The IASB is overseen by the IASC Foundation, much as the FASB is overseen by the Financial Accounting Foundation (FAF). The IASC Foundation has financed IASB operations largely through voluntary contributions from several sources, much like the FAF previously financed the operations of the FASB. (The principal source of financing of the FASB is now the Federal government.) Release 33-8982 specifies that the SEC “will carefully consider the degree to which the IASC Foundation has a secure, stable funding mechanism that permits it to function independently and that enhances the IASB’s standard-setting process.” Release 33-8982 further specifies states: “We believe that our future determination regarding the required use of IFRS for all U.S. issuers should only occur after the IASC Foundation reaches its goal of securing a stable funding mechanism that supports the independent functioning of the IASB.”

Accountability. The SEC observed that national accounting standard setters have been accountable to a national securities regulator or other government body. For example, in the U.S., the FAF, which oversees the FASB, is itself overseen by the SEC. Thus far, the IASC Foundation has not had a similar link with any national securities regulators. Recently, however, the Trustees of the IASC Foundation have proposed amendments to its Constitution to establish a connection between the IASC Foundation and a Monitoring Group composed of securities authorities charged with the adoption or recognition of accounting standards used in their respective jurisdictions. Thus, one of the milestones that has to be achieved is for the IASC Foundation to have amended its Constitution and established an appropriate relationship with this Monitoring Group.

Milestone—Improvement in the Ability to Use Interactive Data for IFRS Reporting

In 2008, the SEC proposed rules that would require companies to provide their financial statements to the SEC and on their corporate websites in interactive data format using XBRL. One of the concerns of the SEC, therefore, would be the state of development of an IFRS list of tags for interactive data reporting.

Milestone—Education and Testing Related to IFRS

A switch to IFRS from U.S. GAAP would require a significant amount of education regarding IFRS. Currently, in the U.S. most of the education and training is focused on U.S. GAAP. The switch to IFRS would require that focus to shift to IFRS. As a part of this focus on IFRS, colleges and universities also would need to incorporate IFRS into their curricula. An attendant issue would be the inclusion of IFRS in the Uniform CPA Exam.

The SEC indicates that it would review the then current status of the overall education, training and readiness of investors, preparers, auditors and other parties prior to proceeding with rulemaking on IFRS for all U.S. issuers.

Milestone—Limited Early Use of IFRS Where This Would Enhance Comparability for U.S. Investors

The SEC is expected to make a decision in 2011 regarding the mandated use of IFRS for U.S. issuers. The SEC is also proposing to allow a limited number of U.S. issuers to adopt IFRS prior to any later mandated use of IFRS for all U.S. issuers. The SEC acknowledged that this early adoption of IFRS would reduce the comparability among U.S. issuers prior to the time of any mandated use of IFRS for all U.S. issuers. Nevertheless, the SEC believes that allowing limited early use of IFRS would enhance the comparability of financial reporting in those particular industries and may help the SEC in its decision of whether to mandate the use of IFRS for all U.S. issuers.

Milestone—Anticipated Timing of Future Rulemaking by the SEC

Under the Roadmap, the SEC would determine in 2011 whether to proceed with a mandated switch to IFRS by 2014. This would mean that the effective switch to IFRS would be 2012. This switch to IFRS would be mandatory, rather than elective. The SEC expects to continue to require that issuers provide three years of audited annual IFRS financial statements. Thus, if 2014 is the year of the mandated switch, in 2014 a calendar-year U.S. issuer would provide IFRS financial statements for 2014, 2013, and 2012. However, during 2012 and 2013, the company would continue to be publicly reporting under existing U.S. GAAP. Thus, for 2012 and 2013, the company would need to be able to develop information under both U.S. GAAP and IFRS.

Milestone—Implementation of the Mandatory Use of IFRS

The SEC is considering the possibility of a staged transition to IFRS, as opposed to all U.S. issuers switching at the same time. Under the staged transition being considered, IFRS filings would begin for large accelerated filers for fiscal years ending on or after December 15, 2014. Accelerated filers would begin IFRS filings for years ending on or after December 15, 2015. Non-accelerated filers would begin IFRS filings for years ending on or after December 15, 2016. Large accelerated filers and accelerated filers are defined in Exchange Act Rule 12b-2. A non-accelerated filer is any filer other than a large accelerated filer or an accelerated filer.

The current economic climate and the desires of the new administration could have an effect on the timing of any switch to IFRS for U.S. issuers. The new Chair of the SEC, Mary Schapiro, has indicated a desire to slow down the switch to IFRS for U.S. issuers. Recently, the Chairman of the FASB indicated that the convergence to IFRS could take 10-15 years. Where the U.S. goes from here is still anyone's guess. However, the switch to IFRS still seems to be *when* rather than *if*.

History and Influence of the IASB

The predecessor of the International Accounting Standards Board (IASB) was the International Accounting Standards Committee (IASC). The IASC was formed in 1973 (ironically, the year the FASB became operational) through an agreement made by professional accountancy bodies from Australia, Canada, France, Germany, Japan, Mexico, the Netherlands, the United Kingdom and Ireland, and the United States of America. The objective of the IASC was to harmonize the accounting principles used by businesses and other organizations for financial reporting around the world. The inaugural meeting of the IASC was June 29, 1973 in London, England.

The international professional activities of the accountancy bodies were organized under the International Federation of Accountants (IFAC) in 1977. In 1981, IASC and IFAC agreed that IASC would have full and complete autonomy in the setting of international accounting standards. At that time, all members of IFAC became members of IASC. This relationship continued until the IASC's constitution was changed in 2000 as part of the reorganization of the IASC at which time this membership link was discontinued.

Barriers to Harmonization

There were numerous barriers to harmonization of accounting principles/standards at that time. The following were some of the major barriers:

- Language
- Differences in legal systems
- Different types of business organizations and ownership
- Different objectives of taxation systems
- Social differences
- Nationalism
- Inability to legally enforce standards
- Differences in economic development

Types and Degrees of Harmonization

There are essentially three types or levels of harmonization. The first could be described as bilateral. An example of a bilateral harmonization would be a treaty between two countries that would allow the financial reporting standards of each of the two countries to be recognized and honored in the other country.

The second type of harmonization is that of regional multilateralism. An example of this type of harmonization would be the agreement among specific nations to adopt a given set of accounting and reporting standards.

The third type of harmonization is that of international multilateralism. An example of this type or degree of harmonization is if the majority (or all) of the nations around the world agreed to adopt a specific set of accounting and reporting standards.

Pronouncements of the IASC

The IASC began by issuing International Accounting Standards (IAS). The IASs were somewhat the counterpart of the FASB's Statements of Financial Accounting Standards. Interpretations of the IASs were issued by the Standing Interpretations Committee (SIC). The role of those interpretations were not unlike those of the FASB Interpretations, except that the SIC was not the same group as the IASC. In contrast, the FASB issued both Statements of Financial Accounting Standards and FASB Interpretations.

The first IAS, *Disclosure of Accounting Policies*, was issued in 1974. The last IAS, IAS 41, *Agriculture*, was issued in 2001. In 1997, the Standing Interpretations Committee (SIC) was formed to issue interpretations of the IASs. These interpretations were identified as SIC Interpretations.

Interaction with IOSCO

During the years the IASC issued the IASs, it sought to have those standards recognized by the International Organization of Securities Commissions (IOSCO). IOSCO reviewed the IASs and indicated to the IASC that the IASs allowed too many alternatives and needed to be improved. In response, the IASC began the process of attempting to improve its standards. This process, known as the comparability project, was completed with the approval of ten revised IASs. The SEC of the United States specifically approved IAS 7, *Cash Flow Statements*. Later, the IASC agreed with IOSCO to complete a group of core standards by 1999. IOSCO agreed that when these core standards were completed, it would consider endorsing IASs for cross-border offerings.

In 2000, IOSCO recommended that its members allow multinational issuers to use 30 IASC standards in cross-border offerings and listings.

International Accounting Standards Board

In 2000, the IASC member bodies approved a restructuring of IASC and a new IASC constitution. The restructured organization includes the IASC Foundation, who appoints the members of the International Accounting Standards Board (IASB), the International Financial Reporting Interpretations Committee (IFRIC), and the Standards Advisory Council (SAC).

The IASB consists of fourteen members (twelve full-time and two part-time) and has full responsibility for setting accounting standards. The IASB issues International Financial Reporting Standards (IFRSs). The publication of a final IFRS requires the approval of nine of the fourteen members of the IASB. In contrast, the FASB consists of five members. The publication of a FASB Statement requires the approval of three of the five members.

Standards Advisory Council

The Standards Advisory Council (SAC) was set up to provide the IASB with advice, agenda decisions, and priorities in its work, and to inform the IASB of the views of the SAC on major standard-setting projects. The SAC consists of forty members and meets at least three times each year.

International Financial Reporting Interpretations Committee

The International Financial Reporting Interpretations Committee (IFRIC) is appointed by the Trustees of the IASC Foundation to assist the IASB in establishing and improving accounting standards. The role of the IFRIC is to provide timely guidance on newly identified financial reporting issues not specifically addressed in IFRS or issues where unsatisfactory or conflicting interpretations have developed, or seem likely to develop.

The IFRIS currently has fourteen voting members in addition to a non-voting Chair. The Trustees of the IASC Foundation also may appoint non-voting observers. Currently, IOSCO and the European Commission are non-voting observers.

Recognition of IASB around the World

Currently, over 100 countries allow or require the use of IFRS. As business entities have become more global the pressure to use one set of accounting standards for all major securities markets has increased. Canada is switching to IFRS by 2011 and, as discussed earlier, the SEC has developed a Work Plan to provide the Commission with the necessary information to determine whether to incorporate IRFS into the U.S. reporting system.

Spelling Differences

There are certain words that are spelled differently in IFRS than in U.S. GAAP. Examples are the spelling of “labour” under IFRS and “labor” under U.S. GAAP and “organisation” under IFRS and “organization” under U.S. GAAP. Throughout this course, the authors have followed the U.S. spelling except in cases of quotes from pronouncements of the IASB, in which case the spelling of the IASB’s pronouncements have been preserved.

IFRS for SMEs (International Financial Reporting Standards for Small and Medium-sized Entities)

Issue Date: July 2009

Effective Date: Effective for financial statements issued upon adoption of the IFRS framework with a one-year delay for implementation of the amendments to IFRS.

Objectives

The objective of financial statements of small or medium-sized entities is to provide information about the financial position, performance, stewardship of management, and cash flows of the entity that is useful for economic decision making by a broad range of external users. IFRS for SMEs focuses on the recognition, measurement, and disclosure principles critical to those entities.

Scope

IFRS for SMEs is intended for use by entities that do not have public accountability and publish general purpose financial statements for external users. (**Note:** IFRS for SMEs is an acceptable framework for U.S. companies upon its effective date.)

Background and Summary of Key Provisions

Global financial reporting standards, consistently applied, enhance the comparability of financial information and thereby improve the efficiency of the allocation and pricing of capital. SMEs can benefit from financial statements that are comparable from country to country in:

- Access to and pricing of cross-border borrowings.
- Access to and terms with vendors and suppliers.
- Developing uniform credit ratings.
- Access to and pricing of venture capital.
- Reporting to outside investors.

IFRS for SMEs is intended for entities that do not have public accountability; have not issued debt or equity securities in a public market; hold assets in a fiduciary capacity as their primary business, e.g., banks, insurance companies, broker/dealers, pension funds, mutual funds, investment banks. There is no size test in defining SMEs. A subsidiary of an entity may use IFRS for SMEs only if it also meets the public accountability test.

IFRS for SMEs is a complete, self-contained set of standards. Reference to any other reporting framework is inappropriate. An entity that elects to report under IFRS for SMEs must make an “explicit and unreserved” declaration to that effect in the notes to the financial statements. And the financial statements must comply with all relevant requirements of the standard.

The following table discusses the major differences in the recognition and measurement principles between IFRS and IFRS for SMEs.

Accounting Principle	IFRS for SMEs	IFRS
Non-current assets (or groups of assets and liabilities) held-for-sale	Holding assets for sale triggers an assessment for impairment.	IFRS 5: Measured a lower of carrying amount and fair value less costs to sell. Depreciation stops when classified as held-for-sale.
Unvested past service cost of defined benefit pension plans	Recognized in profit or loss immediately.	ISA 19: Recognized as an expense on a straight-line basis over the average period until the benefits become vested.
Exchange differences on a monetary item that forms part of the net investment in a foreign operation, in consolidated financial statements	Recognized in OCI and not reclassify in profit or loss on disposal of the investment.	ISA 21: Reclassify in profit and loss on disposal of the investment.
Borrowing costs	Charged to expense.	ISA 23: Capitalize costs directly attributable to the acquisition, construction, or production of qualifying assets.
Investment in an associate for which there is a published price	Measured at fair value through profit and loss.	ISA 28: Measured using the equity method.
Investment in a jointly controlled entity for which there is a published price	Measured at fair value through profit and loss.	ISA 31: Measured using the equity method or proportionate consolidation.
Investment property whose fair value can be measured reliably without undue cost or effort	Measured at fair value through profit and loss.	ISA 40: Choice of either fair value through profit or loss or cost-depreciation-impairment model.
Biological assets	Measured at fair value through profit and loss only if fair value is readily determinable without undue cost or effort.	ISA 41: Presumption that fair value can be readily measured.
Income tax	Where a different tax rate applies to distributed income, initially measure current and deferred taxes at the rate applicable to undistributed profits.	ED, Income Taxes: Initially measure current and deferred taxes at the tax rate expected to apply when the profits are distributed.
Share-based payments with cash alternatives in which the terms of the arrangement provide the counterparty with a choice of settlement	Account for the transaction as a cash-settled share-based payment transaction unless past practice settles the transaction by issuing equity instructions.	IFRS 2: Accounting for a compound instrument.

Accounting Principle	IFRS for SMEs	IFRS
Presentation simplification	Not required to present a statement of financial position at the beginning of the earliest comparable period when applying an accounting policy retrospectively, or there is a retrospective restatement. All deferred tax assets and liabilities classified as non-current. Present a single statement of income and retained earnings in place of separate statements of comprehensive income and changes in equity if the only changes to equity arise from profit or loss, dividends, corrections of errors, and changes in accounting policy.	ISA 1: Required. ED, Income Taxes: Classification as either current or non-current according to the classification of the related nontax asset or liability. Option not available.
Disclosure simplification	Earnings per share. Interim financial reporting. Segment reporting. Special accounting for assets held-for-sale. Financial instruments. Goodwill and other intangibles. Development costs. Income taxes. Employee benefit plans. Share-based payments. Investments and investment property. Government grants. Leases. No review of useful life, residual value and depreciation/ amortization method on an annual basis. Jointly controlled entities. Operating cash flows.	

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following was explicitly recognized by the Securities and Exchange Commission?
 - a. Committee on Accounting Procedure.
 - b. Accounting Principles Board.
 - c. Financial Accounting Standards Board.
2. Which of the following conditions would **not** preclude an entity from qualifying as a foreign private issuer?
 - a. The majority of the executive officers are U.S. citizens or residents.
 - b. More than 50% of the assets of the issuer are located in the U.S.
 - c. The headquarters of the company are located in the U.S.
 - d. The business of the issuer is administered principally in the U.S.
3. Under SEC Release 33-8982, how are U.S. issuers affected concerning the standards to issue financial statements?
 - a. U.S. issuers are mandated to use U.S. GAAP.
 - b. U. S. issuers are mandated to use IFRS as issued by the IASB.
 - c. U.S. issuers are allowed to use financial statements that are presented in accordance with any recognized GAAP they choose.
4. Which of the following is **not** one of the milestones included in the SEC's Roadmap for the potential use of IFRS by U.S. issuers?
 - a. Education and training related to IFRS.
 - b. Funding of the IASC Foundation.
 - c. Accountability of the IASC Foundation.
 - d. Funding of the Financial Accounting Foundation.
5. Which of the following defines a degree of harmonization pertaining to two countries?
 - a. Regional multilateralism.
 - b. Bilateral.
 - c. Unilateral.
 - d. International multilateralism.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

1. Which of the following was explicitly recognized by the Securities and Exchange Commission? **(Pages 5–6)**
 - a. Committee on Accounting Procedure. [This answer is incorrect. The SEC did not explicitly recognize the authoritativeness of the Committee on Accounting Procedure. It issued ASR 4 in 1938 in which it required that accounting principles have substantial authoritative support, but did not specifically mention the Committee on Accounting Procedure.]
 - b. Accounting Principles Board. [This answer is incorrect. The SEC did not explicitly recognize the authoritativeness of the Accounting Principles Board Committee on Accounting Procedure. It issued ASR 4 in 1938 in which it required that accounting principles have substantial authoritative support, but it did not issue any official document in which it explicitly recognized the APB.]
 - c. **Financial Accounting Standards Board. [This answer is correct. The SEC initially explicitly recognized the authoritativeness of the FASB in ASR 150, issued in 1973, and later in SEC Release No. 33-8221.]**
2. Which of the following conditions would **not** preclude an entity from qualifying as a foreign private issuer? **(Page 6)**
 - a. The majority of the executive officers are U.S. citizens or residents. [This answer is incorrect. An entity for which the majority of its executive officers are U.S. citizens or residents is a characteristic that would preclude the entity from being a foreign private issuer. In this case, the entity would be identified as a U.S. issuer.]
 - b. More than 50% of the assets of the issuer are located in the U.S. [This answer is incorrect. If more than 50% of the assets of the issuer are located in the U.S. that entity cannot qualify as a foreign private issuer. Instead, it would be considered to be a U.S. issuer.]
 - c. **The headquarters of the company are located in the U.S. [This answer is correct. The fact that the headquarters is located in the U.S. does not, of itself, prevent the entity from qualifying as a foreign private issuer. The entity cannot qualify as a foreign private issuer if (1) more than 50% of the issuer's outstanding voting securities are directly or indirectly held of record by residents of the United States; or (2) if any of the following are true: (i) the majority of the executive officers or directors are United States citizens or residents; (ii) more than 50% of the assets of the issuer are located in the United States; or (iii) the business of the issuer is administered principally in the United States.]**
 - d. The business of the issuer is administered principally in the United States. [This answer is incorrect. The fact that the business of the issuer is administered principally in the U.S. would preclude the entity from qualifying as a foreign private issuer. Since the business is administered principally in the U.S. the entity would qualify as a U.S. issuer.]

3. Under SEC Release 33-8982, how are U.S. issuers affected concerning the standards to issue financial statements? **(Page 7)**
- a. U.S. issuers are mandated to use U.S. GAAP. [This answer is incorrect. U.S. issuers would not be mandated to use U.S. GAAP. They are already mandated to use U.S. GAAP, so the mandated use of U.S. GAAP would not represent a change.]
 - b. U.S. issuers are mandated to use IFRS as issued by the IASB. [This answer is correct. Under SEC Release 33-8982, all U.S. issuers would be mandated to switch from U.S. GAAP to IFRS as issued by the IASB.]**
 - c. U.S. issuers are allowed to use financial statements that are presented in accordance with any recognized GAAP they choose. [This answer is incorrect. Release 33-8982 would not allow U.S. issuers to use any recognized GAAP they choose. Rather, they would have to use a particular set of standards.]
4. Which of the following is **not** one of the milestones included in the SEC's Roadmap for the potential use of IFRS by U.S. issuers? **(Page 8)**
- a. Education and training related to IFRS. [This answer is incorrect. The education and training related to IFRS is one of the milestones. The SEC indicates that it will review the status of the overall education, training and readiness of investors, preparers, auditors and other parties prior to proceeding with rulemaking on IFRS for all U.S. issuers.]
 - b. Funding of the IASC Foundation. [This answer is incorrect. Funding of the IASC Foundation is one of the milestones. The SEC indicated that future determination regarding the required use of the IFRS for all U.S. issuers should only occur after the IASC Foundation reaches its goal of securing a stable funding mechanism that supports the independent functioning of the IASB.]
 - c. Accountability of the IASC Foundation. [This answer is incorrect. Accountability of the IASC Foundation is one of the milestones. The SEC indicated that any switch to IFRS for U.S. issuers will require the IASC Foundation to have amended its Constitution and established an appropriate relationship with the Monitoring Group.]
 - d. Funding of the Financial Accounting Foundation. [This answer is correct. Funding of the Financial Accounting Foundation would be an issue if the SEC continued to require U.S. GAAP, but it is not an issue for any possible switch from U.S. GAAP to IFRS.]**

5. Which of the following defines a degree of harmonization pertaining to two countries?
(Page 11)

- a. Regional multilateralism. [This answer is incorrect. Regional multilateralism is a degree of harmonization involving the agreement between specific nations to adopt a given set of accounting and reporting standards.]
- b. Bilateral. [This answer is correct. Bilateral harmonization would be a treaty between two countries that would allow the financial reporting standards of each of the two countries to be recognized and honored in the other country.]**
- c. Unilateral. [This answer is incorrect. Unilateral is something undertaken by one party or in this example, by one country.]
- d. International multilateralism. [This answer is incorrect. International multilateralism would involve all countries around the world or at least a majority of the countries.]

EXAMINATION FOR CPE CREDIT

Chapter 1

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

1. Which of the following was a major difference between the Committee on Accounting Procedure (CAP) and the Accounting Principles Board (APB)?
 - a. The development of a conceptual framework.
 - b. The existence of a formal research division within the AICPA.
 - c. The APB was explicitly recognized by the SEC but CAP was not.
 - d. Do not select this answer choice.
2. How was the FASB created?
 - a. Through the Trueblood Committee of the AICPA.
 - b. Through an Act of Congress.
 - c. Through the Wheat Committee of the AICPA.
 - d. Through the International Accounting Standards Board.
3. Which of the following best describes the role and impact of the Securities Exchange Commission?
 - a. To formally recognize the private-sector standard-setting body and to impact these standards by frequently overriding the private-sector standard-setting body.
 - b. To establish the FASB and to impact the private-sector standard setting body by recognizing FASB as the authoritative standard-setting body.
 - c. To administer the Securities Act of 1933 and the Exchange Act of 1934 with an impact on the private-sector standard-setting body.
 - d. To administer the Sarbanes-Oxley Act of 2002 and to impact the conceptual framework of the FASB.

4. Under the SEC's Work Plan, in which year will the SEC determine whether to proceed with a mandated switch to IFRS?
 - a. 2011.
 - b. 2012.
 - c. 2014.
 - d. 2015.

5. What is the number of countries around the world that allow or require the use of IFRS?
 - a. Less than 25.
 - b. 25–50.
 - c. 51–100.
 - d. Greater than 100.

Chapter 2: Financial Statement Presentation

Introduction

This chapter discusses the presentation of items in the financial statements under IFRS.

Learning Objectives

Completion of this chapter will enable you to:

- Identify the basic requirements of IFRS-based financial statements.
- Differentiate between U.S. GAAP financial statements and IFRS-based financial statements.

General Financial Statement Issues

The FASB and the IASB have been working on a joint project on financial statement presentation for several months. The IASB was the first of the two Boards to update its pronouncements with respect to the general issue of financial statement presentation. Thus, the IASB's IFRS and IASs reflect some of the outgrowth of the two Boards' joint project that have not yet been incorporated into the FASB's pronouncements.

There are some items currently addressed in the IASB's accounting pronouncements that have historically been addressed in the auditing literature in the U.S. For example, IAS 1, *Presentation of Financial Statements*, specifies that "when preparing financial statements, management shall make an assessment of an entity's ability to continue as a going concern. An entity shall prepare financial statements on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so." (IAS 1, ¶25) The going concern issue tends to be addressed in the auditing literature rather than in the accounting literature in the U.S.

Purpose of Financial Statements

The IASB's acknowledged purpose of financial statements is similar to that of the FASB. The IASB specifically states that the objective of financial statements is "to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions." (IAS 1, ¶9)

Complete Set of Financial Statements

The IASB specifies that a complete set of financial statements includes:

- a. A statement of financial position at the end of the period,
- b. A statement of comprehensive income for the period,
- c. A statement of changes in equity for the period,
- d. A statement of cash flows for the period,

- e. Notes, comprising a summary of significant accounting policies and other explanatory information, and
- f. A statement of financial position as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements. (**IAS 1, ¶10**)

Examples of the four IFRS-based financial statements of M&M Corporation described in a–d above are presented in the Appendix.

The Issue of Comparative Financial Statements

The IASB requires that “except when IFRS permit or require otherwise, an entity shall disclose comparative information in respect of the previous period for all amounts reported in the current period’s financial statements.” (**IAS 1, ¶38**) Thus, the IASB requires comparative financial statements for a minimum of two years. Currently, the FASB has no such requirement. While the SEC specifies a minimum number of financial statements, the FASB does not.

In addition, the IASB requires that a statement of financial position be presented at the beginning of the earliest year presented when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements or when it reclassifies items in its financial statements. Thus, if an entity applies an accounting policy retrospectively, makes a retrospective restatement of items in its financial statements, or reclassifies items in its financial statements, it must present a minimum of three statements of financial position, one at the end of each year presented and one at the beginning of the earliest year presented.

IAS 1 allows for the possibility that compliance with a requirement in an IFRS would be so misleading that it would conflict with the objective of financial statements specified by the IASB. In that case, the entity should depart from the IFRS requirement and make certain disclosures “if the relevant regulatory framework requires, or otherwise does not prohibit, such a departure.” (**IAS 1, ¶19**) This position is somewhat similar to that in the U.S., except that the U.S. position is found in Rule 203, “Accounting Principles” of the AICPA Code of Professional Conduct rather than in the FASB Accounting Standards Codification.

Reporting Comprehensive Income

IFRS and U.S. GAAP both define *comprehensive income* as the sum of net income and other comprehensive income. Additionally, both require that other comprehensive income be presented in a financial statement. IFRS requires that comprehensive income be presented in one of two ways:

- a. A single statement of comprehensive income, or
- b. Two statements,
 - 1) The first statement being an income statement that ends with net income (IFRS also use the term “profit or loss”) and
 - 2) A second statement that begins with net income, includes the components of other comprehensive income, and ends with the total comprehensive income.

The latter approach (approach b, which utilizes two statements) is demonstrated in the illustrative IFRS-based financial statements of M&M Corporation.

U.S. GAAP allows both of these options, but also allows a third choice in which the total of net income, the components of other comprehensive income, and the total of comprehensive income are presented in a statement of changes in stockholders' equity. IFRS **do not** allow this third choice.

Income Statement Minimum Line Items

IAS 1 allows some flexibility as to the specific form of the income statement. It specifies the following minimum line items, however:

- Revenue,
- Finance costs,
- Share of the profit or loss of associates and joint ventures accounted for under the equity method,
- Tax expense,
- Discontinued operations, and
- Profit or loss. (IAS 1, ¶82)

Extraordinary Items

IAS 1 prohibits the presentation of any items of income or expense as extraordinary items in the income statement, statement of comprehensive income, or the related notes. This prohibition is in contrast to U.S. GAAP, which requires that gains and losses that meet certain criteria be presented as extraordinary items.

Discontinued Operations

IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, essentially converges IFRS with FASB ASC 360 (formerly SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*). Similar to the case of U.S. GAAP, IFRS 5 requires that an item qualify as a component to be presented in discontinued operations. The general definition of a component is the same in IFRS 5 as in FASB ASC 360; both specify that a component “comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.” (IFRS 5, ¶31; FASB ASC 740-270-20)

Earnings per Share (EPS)

Entities with publicly traded ordinary shares, or that are in the process of issuing such shares, must disclose EPS. FASB ASC 260 (formerly SFAS 128, *Earnings per Share*), and IAS 33, *Earnings per Share*, are essentially the same. Both standards require the presentation of basic and diluted EPS on the face of the income statement. Both use the treasury stock method for calculating the effects of stock options and warrants on diluted earnings per share. There are a few application differences as discussed below.

Contracts that may be settled in shares or cash

U.S. GAAP assumes that such contracts will be settled in shares unless there is evidence to the contrary. IFRS assume the contracts will *always* be settled in shares.

Treasury Stock Method and Contingent Shares

For options and warrants, and contingently diluted EPS under U.S. GAAP, an entity computes a year-to-date weighted average of the number of incremental shares included in each quarterly calculation. Under IFRS, the entity does not average the quarterly periods, but rather treats the entire year-to-date period as a “period” in the calculation.

Contingently Convertible Debt

U.S. GAAP considers the shares as “potentially dilutive securities,” as such they would be included in diluted EPS using the if-converted method. Under IFRS the shares truly are “contingently issuable” and are included in diluted EPS if, and only if, the contingency is met at the end of the reporting period.

Convergence

The IASB and the FASB are working on a convergence project to resolve the differences in the standards. Tentatively, the boards have agreed to adopt many of the approaches used in the IFRS to eliminate the differences.

Additionally, no longer will instruments that may be settled in cash or shares be included in diluted EPS. Other issues to be addressed include the effect of options and warrants on basic EPS, and modifications of the treasury stock method to (a) require the use of the end-of-period share price in calculating the shares hypothetically repurchased (rather than the average share price for the period), and (b) for liabilities that are not remeasured at fair value, to include the carrying amount of the liability within the assumed proceeds used to hypothetically repurchase shares.

Reporting Other Comprehensive Income

IAS 1 requires an entity to disclose the amount of income tax related to each component of other comprehensive income, including reclassification adjustments. These disclosures may be made either in the other comprehensive income section or in the notes.

The components of other comprehensive income may be presented either net of any related tax effects or before any related tax effects with a single amount shown for the aggregate amount of income tax relating to those components.

Components of Other Comprehensive Income

Under IAS 1, the components of other comprehensive income include:

- Changes in revaluation surplus under IAS 16, *Property, Plant and Equipment* and IAS 38, *Intangible Assets*,
- Actuarial gains and losses on defined benefit plans recognized in accordance with IAS 19, *Employee Benefits*,
- Gains and losses arising from translating the financial statements of a foreign operation,
- Gains and losses on remeasuring available-for-sale financial assets, and
- The effective portion of gains and losses on hedging instruments in a cash flow hedge.
(IAS 1, ¶7)

Therefore, the components of other comprehensive income under IFRS are essentially the same as those under U.S. GAAP, except for the changes in revaluation surplus identified above.

Statement of Financial Position

While IFRS requires specific information be presented in the statement of financial position, there is no set format for the statement. Generally, an entity must present its statement of financial position with items classified as either current or non-current. An unclassified statement of financial position is acceptable *only if* it provides more reliable and more relevant information. If using an unclassified statement of financial position, the entity must present all assets and liabilities in order of liquidity.

U.S. GAAP does not require a classified statement of financial position nor is there a restriction as to when an entity may present an unclassified statement of financial position. However, unlike IFRS, the SEC does prescribe the format and minimum line item disclosures for its registrants. For non-SEC registrants there is little guidance on the presentation of the statement of financial position.

At a minimum the statement of financial position must include line items that present the following amounts, if applicable:

- a. Property, plant and equipment
- b. Investment property
- c. Intangible assets
- d. Financial assets (excluding amounts shown under (e), (h) and (i))
- e. Investments accounted for using the equity method
- f. Biological assets
- g. Inventories
- h. Trade and other receivables
- i. Cash and cash equivalents

- j. The total of assets classified as held for sale and assets included in disposal groups classified as held for sale in accordance with IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*
- k. Trade and other payables
- l. Provisions
- m. Financial liabilities (excluding amounts shown under (k) and (l))
- n. Liabilities and assets for current tax, as defined in IAS 12, *Income Taxes*
- o. Deferred tax liabilities and deferred tax assets, as defined in IAS 12
- p. Liabilities included in disposal groups classified as held for sale in accordance with IFRS 5;
- q. Noncontrolling interests, presented within equity
- r. Issued capital and reserves attributable to owners of the parent (**IAS 1, ¶54**)

Remember, this list is not dictating the order of presentation in the statement of financial position, but the line items that must be presented. An entity may include more line items, headings and subtotals in the statement if the information is pertinent to an understanding of the entity's financial position.

Order of Presentation

In the illustrative financial statements of M&M Corporation notice that the non-current assets are presented before the current assets and the equity and non-current liabilities are presented before the current liabilities. There is no requirement in IFRS for this order of presentation. This is simply a cultural difference between the U.S. and most European countries.

While the assets and liabilities of M&M Corporation are presented as current and non-current, this is not a presentation prescribed by IFRS. Assets and liabilities may be presented in order of liquidity if that presentation provides reliable and more relevant information. For example, for financial institutions a presentation of assets and liabilities in order of liquidity provides information that is reliable and more relevant than a current/non-current presentation because a financial institution does not supply goods or services within a clearly identifiable operating cycle.

An entity with diverse operations may use a mixed basis of presentation, i.e., some assets and liabilities presented using a current/non-current classification and others presented in the order of liquidity. This presentation may provide information that is reliable and more relevant than either a current/non-current or order of liquidity presentation alone.

Regardless of which presentation an entity uses, it must disclose the amount expected to be recovered or settled after more than 12 months for each line item that combines amounts expected to be recovered or settled: (a) no more than 12 months after the reporting period, and (b) more than twelve months after the reporting period.

Current Assets

Under IAS 1, an asset is classified as current when it is:

- Expected to be realized, sold or consumed, in a normal operating cycle;
- Held primarily for the purpose of trading;
- Expected to be realized within twelve months after the reporting period; or
- Cash or a cash equivalent (as defined in IAS 7, *Statement of Cash Flows*) unless the asset is restricted from being exchanged or used to settle a liability for at least twelve months after the reporting period.

All other assets are classified as non-current.

This definition differs from U.S. GAAP. According to FASB ASC 210-10-20 (formerly ARB 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 3, "Working Capital)," the term "current assets" is simply defined as cash and other assets or resources which are reasonably expected to be realized in cash or sold or consumed during the normal operating cycle of the business.

Current Liabilities

A liability is classified as current when the entity:

- Expects to settle the liability in a normal operating cycle;
- Holds the liability primarily for the purpose of trading;
- Expects to settle the liability within twelve months after the reporting period; or
- Does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period. Terms of a liability that could at the option of the counterpart, result in its settlement by the issue of equity instruments do not affect its classification.

All other liabilities are classified as non-current.

This definition differs little from U.S. GAAP. According to FASB ASC 210-10-20, the term "current liabilities" is more succinctly defined as obligations whose liquidation is reasonably expected to require the use of existing resources properly classifiable as current assets, or the creation of other current liabilities.

One major difference between U.S. GAAP and IFRS is with current liabilities expected to be refinanced. Under U.S. GAAP, a liability that is considered current at year-end may be classified as non-current if it is refinanced by the date the financial statements are issued. According to IFRS, the liability could only be classified as non-current if the refinancing had been completed by year-end. In other words, the subsequent refinancing of the debt after year-end does not affect its classification in the statement of financial position.

Property, Plant and Equipment

U.S. GAAP and IFRS are very similar in accounting for property, plant and equipment. Under both, an entity would initially record property, plant and equipment at cost. Cost includes any cost necessary to get the asset ready for its intended use. Also included is the cost of dismantling and removing the asset and restoring the site. If the estimated costs of decommissioning and restoration change, the entity adjusts the cost of the related asset.

Under U.S. GAAP and IFRS, an entity depreciates property, plant and equipment over its useful life, even if idle, but not if it is held for sale. Under IFRS, an entity must annually review the estimates of residual value, life, and depreciation method; whereas, under U.S. GAAP the review only occurs when a change in circumstances or events indicate that the estimates may no longer be appropriate. Both account for any changes in depreciation estimates prospectively.

Unlike U.S. GAAP, IFRS *requires* that an entity separately depreciate each part of an item of property, plant and equipment with a cost that is significant in relation to the total cost of the item (U.S. GAAP *allows* this treatment, but does not require it). For example, depreciating separately the airframe and engines of an aircraft might be appropriate. IFRS allows an entity to separately depreciate each part of an item that does not have a cost that is significant in relation to the total cost of the item.

A major difference between U.S. GAAP and IFRS is that under IFRS, an entity may revalue property, plant and equipment to fair value if fair value is reliably measureable. The entity must revalue property, plant and equipment with such regularity to ensure that the assets' carrying amounts do not materially differ from their fair values at the end of the reporting period.

The revaluation of property, plant and equipment is discussed in more detail in a subsequent chapter.

Intangible Assets and Goodwill

Like U.S. GAAP, an *intangible asset* (a) is an identifiable non-monetary asset lacking physical substance, (b) is initially recorded at cost, and (c) with a finite useful life is amortized over its expected useful life. Under U.S. GAAP and IFRS, goodwill is only recognized in a business combination and is measured as a residual. Under either set of standards, an entity does not amortize goodwill and other intangible assets with an indefinite life but must test them at least annually for impairment.

Under IFRS, intangible assets may be revalued to fair value, but only if there is an active market. Like property, plant and equipment, an entity must revalue intangible assets with such regularity to ensure that the intangibles' carrying amounts do not materially differ from their fair values at the end of the reporting period.

Equity

By tradition, the equity accounts are presented before liabilities in the statement of financial position and non-current liabilities are presented before current liabilities (illustrated in the statement of financial position for M&M Corporation). Both U.S. GAAP and IFRS require non-controlling interests (formerly referred to as minority interests) to be shown in the statement of financial position separately from controlling interests (parent's shareholders' equity).

Statement of Cash Flows

IAS 7, *Statement of Cash Flows*, requires an entity to present a statement of cash flows as an integral part of the financial statements for each period that financial statements are presented.

The primary purpose of the statement of cash flows is to provide users with a basis of assessing the ability of an entity to generate cash and cash equivalents and the needs of the entity to utilize those cash flows. One objective of IAS 7 is to provide users with information about the historical changes in cash and cash equivalents via a statement of cash flows that classifies cash flows during the period into **operating**, **investing**, and **financing** activities.

Presentation of Operating Cash Flows

Like FASB ASC 230 (formerly SFAS 95, *Statement of Cash Flows*), IAS 7 allows an entity to calculate cash provided by operations using either the direct method or indirect method. In addition, like FASB ASC 230, IAS 7 encourages use of the direct method, but does not require its use. Unlike U.S. GAAP, IFRS do not specify the categories of cash flows that must be presented.

Classification of Cash Receipts and Cash Payments

Unlike U.S. GAAP, if a cash receipt or payment possesses the attributes of more than one class of cash flow, the various components of the cash flow are classified as operating, investing, or financing. According to FASB ASC 230, the cash flows are classified based on the principal source of cash flow, unless the underlying transaction is accounted for as having different components.

Cash and Cash Equivalents

IAS 7 defines *cash* as cash on hand and demand deposits. *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. Similarly to U.S. GAAP, for an investment to be a cash equivalent it must readily be convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as a cash equivalent only if it has a short maturity of three months or less from the date of acquisition.

One difference between IFRS and U.S. GAAP is that in certain circumstances IFRS allow an entity to include bank overdrafts as cash.

In some countries, bank overdrafts which are repayable on demand form an integral part of an entity's cash management. In these situations, an entity would include bank overdrafts as a part of cash and cash equivalents. A characteristic of such banking arrangements is that the bank balance often fluctuates from being positive to overdrawn.

Interest and Dividends

For financial institutions, interest paid and interest and dividends received are typically classified as operating cash flows; however, there is no agreement on the classification of these cash flows for other entities. For example, the repayment of a loan affects both interest

and liabilities. According to U.S. GAAP the interest component is classified as an operating activity (because it is a separate component and it affects net income) and the liability component is classified as a financing activity; however, under IFRS the interest component may be classified as either an operating activity or a financing activity because the interest is the cost of obtaining financial resources.

IAS 7 requires an entity to disclose the total amount of interest paid during a period in the statement of cash flows, regardless of whether the entity is using the direct or indirect presentation of cash provided by operating activities. FASB ASC 230 requires the disclosure of interest paid, but the disclosure may be made in a footnote to the statement of cash flows. Another difference is that FASB ASC 230 requires the disclosure of interest paid, net of capitalized interest, whereas, IAS 7 requires the disclosure of *all* interest paid, whether it has been recognized as an expense or capitalized.

Dividends received may be classified as an investing cash flow because they are returns on investments or as an operating cash flow.

Regardless of how an entity classifies interest paid and interest and dividends received, they should be classified in a consistent manner from period to period as operating, investing or financing activities.

Income Taxes Paid

IAS 7 requires an entity to separately disclose cash flows arising from taxes as cash flows from operating activities unless the taxes can be specifically identified with financing and investing activities. Generally, separate identification is impracticable, and thus too costly. However, when it is practicable to associate the tax cash flow with a transaction giving rise to cash flows that are classified as investing or financing activities the tax cash flow is classified as an investing or financing activity as appropriate.

While FASB ASC 230 requires the disclosure of cash paid for income taxes, the FASB decided that to allocate income taxes between operating, investing, and financing activities was too complicated and arbitrary to justify the costs involved. Therefore, income taxes paid are disclosed as operating activities.

Statement of Changes in Owners' Equity

IAS 1 requires that an entity present a statement of changes in equity that shows—

- Total comprehensive income for the period, showing separately the total amounts attributable to owners of the parent and to non-controlling interests;
- For each component of equity, the effects of retrospective application of an accounting principle or retrospective restatement recognized as a result of corrections of errors;
- For each component of equity, a reconciliation between the carrying amount at the beginning and the end of the period, separately disclosing changes resulting from:
 - Profit or loss;
 - Each item of other comprehensive income; and
 - Transactions with owners in their capacity as owners, showing separately contributions by and distributions to owners and changes in ownership interests in subsidiaries that do not result in a loss of control.

The requirement that comprehensive income for the period be separated into the amount attributable to the parent and to the noncontrolling interests is similar to that of U.S. GAAP after FASB ASC 810 (formerly SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements*). In similar fashion, the requirement that the statement of changes in owners' equity report the retrospective application of an accounting principle or the retroactive restatement recognized as a result of a correction of an error is similar to the requirements of FASB ASC 250 (formerly SFAS 154, *Accounting Changes and Error Corrections*).

IFRS and U.S. GAAP differ significantly in the manner in which other comprehensive income may be reported. IFRS requires that the current-period changes in other comprehensive income items must be reported in—

- A single statement of comprehensive income; or
- Two statements:
 - The first statement being an income statement that ends with net income, and
 - A second income statement that begins with net income, includes the components of other comprehensive income, and ends with total comprehensive income.

IAS 1 does not allow the other comprehensive income items to be reported only in the statement of changes in owners' equity. U.S. GAAP allows such reporting of other comprehensive income items.

Both IFRS and U.S. GAAP require that the changes in accumulated other comprehensive income be reported on the statement of changes in owners' equity.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. Which of the following is **not** required by the IASB to be presented as a basic financial statement?
 - a. Statement of financial position.
 - b. A statement of cash flows.
 - c. A comprehensive income statement.
 - d. A statement of changes in plant assets.
7. The IASB requires financial statements for how many years?
 - a. At least two years.
 - b. At least three years.
 - c. Only a single year.
8. Under IFRS, which of the following is **not** an acceptable way to report comprehensive income?
 - a. As a single statement of comprehensive income that reports the components of net income and the components of other comprehensive income.
 - b. As two separate statements, with the first statement being an income statement and the second a statement of comprehensive income that begins with net income, includes the components of other comprehensive income, and ends with the total comprehensive income.
 - c. In a statement of changes in owner's equity.
9. Which of the following is **not** one of the minimum line-items that must be presented under IFRS in the income statement portion of the comprehensive income statement?
 - a. Revenue.
 - b. Income tax expense.
 - c. Extraordinary items.
 - d. Discontinued operations.
10. The components of other comprehensive income under IFRS include which of the following?
 - a. Gains and losses on remeasuring available-for-sale financial assets.
 - b. Gains and losses on remeasuring financial assets classified as trading securities.
 - c. Discontinued operations.
 - d. Extraordinary items.

11. Which of the following presentation formats are required by IFRS for the statement of financial position?
- a. Current assets must be presented before non-current assets.
 - b. Current liabilities must be presented immediately after current assets.
 - c. Non-current assets must be presented before current assets.
 - d. IFRS does not specify a format for the statement of financial position.
12. The plant manager for Owing Corporation is expecting new replacement equipment to arrive. To prepare for the arrival, some costs will be paid. From the list below, select the cost items which can be recorded in the financial statements as a cost of the replacement asset under GAAP and IFRS.
- i. Cost to dismantle the old equipment.
 - ii. Preparation of the foundation to bear the weight of the new equipment.
 - iii. Shipping and uncrating charges.
 - iv. Set up charges.
 - v. Lubrication oil for the new equipment.
- a. Items i and ii are included in the asset cost under GAAP but not IFRS. All other items are expenses.
 - b. All items except iii and iv are included in the asset cost under IFRS but not GAAP.
 - c. Items i through iv would be considered part of the cost of the new asset under both GAAP and IFRS.
13. In the statement of cash flows, how does IFRS require interest paid to be reflected?
- a. As an operating activity because interest expense is included on the income statement.
 - b. As a financing activity because interest arises from a liability.
 - c. As not only interest that was recognized as an expense, but also interest that was capitalized.
14. In the statement of cash flows, how does IFRS require income taxes paid to be reflected?
- a. As an operating activity, because income tax expense is included on the income statement.
 - b. As an investing or financing activity when practicable with the transaction that gives rise to the cash flow.
 - c. As a financing activity, because income tax payable is a liability.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

6. Which of the following is **not** required by the IASB to be presented as a basic financial statement? **(Page 23)**
- a. Statement of financial position. [This answer is incorrect. The IASB specifies that a statement of financial position should be included in the basic financial statements. This requirement is similar to that of the FASB in the U.S. The statement of financial position shows the assets, liabilities, and owners' equity at a moment in time.]
 - b. A statement of cash flows. [This answer is incorrect. The IASB specifies that a statement of cash flows should be included in the basic financial statements. This requirement is similar to that of the FASB in the U.S. The statement of cash flows shows all receipts and disbursements of cash during the period.]
 - c. A comprehensive income statement. [This answer is incorrect. The IASB specifies that a comprehensive income statement should be included in the basic financial statements. The comprehensive income statement reflects all non-owner changes in equity.]
 - d. **A statement of changes in plant assets. [This answer is correct. A statement of changes in plant assets is not required by the IASB. While management might choose to prepare such a statement, it is not a required statement.]**
7. The IASB requires financial statements for how many years? **(Page 24)**
- a. **At least two years. [This answer is correct. IAS 1 requires an entity to disclose comparative information in respect of the previous period, i.e., to disclose as a minimum two of each of the statements and related notes.]**
 - b. At least three years. [This answer is incorrect. The IASB does not require financial statements for at least three years. While a given regulatory agency, such as the SEC, may have such a requirement, the IASB does not.]
 - c. Only a single year. [This answer is incorrect. The IASB requires that financial statements be presented for multiple years.]
8. Under IFRS, which of the following is **not** an acceptable way to report comprehensive income? **(Page 24)**
- a. As a single statement of comprehensive income that reports the components of net income and the components of other comprehensive income. [This answer is incorrect. This approach is an acceptable way to report comprehensive income. The advantage of this approach is that all components of comprehensive income are presented in a single financial statement.]

- b. As two separate statements, with the first statement being an income statement and the second a statement of comprehensive income that begins with net income, includes the components of other comprehensive income, and ends with the total comprehensive income. [This answer is incorrect. The presentation as two separate statements is acceptable. The advantage of using the two statements approach is that the traditional income statement is presented as it has been in the past, which provides a degree of familiarity for users. The components of other comprehensive income are separated from the income statement.]
 - c. **In a statement of changes in owner's equity. [This answer is correct. This approach is allowed by U.S. GAAP, but is not acceptable under IFRS.]**
9. Which of the following is **not** one of the minimum line-items that must be presented under IFRS in the income statement portion of the comprehensive income statement? **(Page 25)**
- a. Revenue. [This answer is incorrect. Revenue is one of the required line-items. Revenue is the inflow of net assets from the sale of goods and services.]
 - b. Income tax expense. [This answer is incorrect. Income tax expense is a required line-item. It is the amount of taxes on an accrual basis and not necessarily the amount of taxes paid.]
 - c. **Extraordinary items. [This answer is correct. IFRS prohibits the presentation of any gain or loss as an extraordinary item.]**
 - d. Discontinued operations. [This answer is incorrect. Assuming it has discontinued operations during the period, an entity is required to present discontinued operations as a separate line-item. Discontinued operations represent the results of disposing of a component or the impairment loss associated with a component held for sale.]
10. The components of other comprehensive income under IFRS include which of the following? **(Page 27)**
- a. **Gains and losses on remeasuring available-for-sale financial assets. [This answer is correct. IAS 1 specifies that gains and losses on remeasuring available-for-sale financial assets must be included as a component of other comprehensive income.]**
 - b. Gains and losses on remeasuring financial assets classified as trading securities. [This answer is incorrect. These gains and losses are included in the determination of net income.]
 - c. Discontinued operations. [This answer is incorrect. Discontinued operations are included in the determination of net income, but are not included in other comprehensive income.]
 - d. Extraordinary items. [This answer is incorrect. IAS 1 does not allow the presentation of a gain or loss in comprehensive income as an extraordinary item.]

11. Which of the following presentation formats are required by IFRS for the statement of financial position? **(Page 27)**
- a. Current assets must be presented before non-current assets. [This answer is incorrect. While this is an acceptable presentation, it is not required by IFRS.]
 - b. Current liabilities must be presented immediately after current assets. [This answer is incorrect. While this “working capital” approach would be acceptable under IFRS, it is not required.]
 - c. Non-current assets must be presented before current assets. [This answer is incorrect. This is the “traditional” approach used by many European countries, but it is not required by IFRS.]
 - d. **IFRS does not specify a format for the statement of financial position. [This answer is correct. Even though specific information is required to be presented in the statement of financial position, IFRS does not require a specific format for the statement of financial position. All of the methods listed are acceptable.]**
12. The plant manager for Owing Corporation is expecting new replacement equipment to arrive. To prepare for the arrival, some costs will be paid. From the list below, select the cost items which can be recorded in the financial statements as a cost of the replacement asset under GAAP and IFRS. **(Page 30)**
- i. Cost to dismantle the old equipment.
 - ii. Preparation of the foundation to bear the weight of the new equipment.
 - iv. Shipping and uncrating charges.
 - iv. Set up charges.
 - v. Lubrication oil for the new equipment.
- a. Items i and ii are included in the asset cost under GAAP but not IFRS. All other items are expenses. [This answer is incorrect. There are more charges in the list that are recognized in the cost of the new asset under both GAAP and IFRS.]
 - b. All items except iii and iv are included in the asset cost under IFRS but not GAAP. [This answer is incorrect. One of the items listed would be considered an expense under IFRS and GAAP.]
 - c. **Items i through iv would be considered part of the cost of the new asset under both GAAP and IFRS. [This answer is correct. U.S. GAAP and IFRS are very similar in accounting for property, plant and equipment. The cost of a new asset includes any cost necessary to get the asset ready for its intended use. Generally the cost of lubrication only would be an expense item and not capitalized as part of the cost of equipment.]**

13. In the statement of cash flows, how does IFRS require interest paid to be reflected?
(Page 32)

- a. As an operating activity because interest expense is included on the income statement. [This answer is incorrect. While interest paid may be reported as an operating activity, there is no requirement that it be reported as such.]
- b. As a financing activity because interest arises from a liability. [This answer is incorrect. IAS 7 allows interest to be reported as a financing activity if the interest is the cost of obtaining financial resources.]
- c. **As not only interest that was recognized as an expense, but also interest that was capitalized. [This answer is correct. SFAS 95 requires the disclosure of interest paid, net of capitalized interest, however IAS 7 requires the disclosure of all interest paid, whether it has been recognized as an expense or capitalized.]**

14. In the statement of cash flows, how does IFRS require income taxes paid to be reflected?
(Page 32)

- a. As an operating activity, because income tax expense is included on the income statement. [This answer is incorrect. IAS 7 does not require income taxes paid to be shown as an operating activity.]
- b. **As an investing or financing activity when practicable with the transaction that gives rise to the cash flow. [This answer is correct. If income taxes can be specifically identified with a financing or investing activity and it is practicable to associate the taxes with the investing or financing activity, then the taxes should be disclosed as an investing or financing activity.]**
- c. As a financing activity, because income tax payable is a liability. [This answer is incorrect. A tax liability has no impact on the disclosure of income taxes in the statement of cash flows.]

EXAMINATION FOR CPE CREDIT

Chapter 2

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

6. What is the minimum number of statements of financial position that is required by the IASB for an entity that applies an accounting policy retrospectively?
 - a. 3.
 - b. 2.
 - c. 1.
 - d. 0.

7. Which of the following would **not** be presented under IFRS as a component of other comprehensive income?
 - a. Gains and losses arising from translating the financial statements of a foreign operation.
 - b. Finance costs.
 - c. The effective portion of gains and losses on hedging instruments in a cash flow hedge.
 - d. Do not select this answer choice.

8. When does IFRS allow assets and liabilities to be presented in order of liquidity in the statement of financial position?
 - a. When the entity is a financial institution.
 - b. When that presentation provides information that is reliable and more relevant than a current/non-current presentation.
 - c. When that is the presentation the entity wants to use, because there is no prescribed presentation format.
 - d. When current assets are greater than non-current assets and current liabilities are greater than non-current liabilities.

9. An entity has an obligation that is due within the next reporting period, but the entity intends to refinance the liability on a long-term basis before maturity. How does IFRS require the obligation be reported?
- a. As a non-current liability because it will be refinanced on a long-term basis.
 - b. As a non-current liability, if the liability is refinanced before the financial statements are issued.
 - c. As a current or non-current, depending on the entity's policy.
 - d. As a current liability.
10. Under IFRS, how often must an entity review depreciation estimates?
- a. Quarterly.
 - b. Annually.
 - c. When a change in circumstances or events indicate that the estimates may no longer be appropriate.
 - d. Every time a statement of financial position is issued.
11. A cash receipt or payment may have attributes of more than one class of cash flows. What is the IFRS requirement for classifying the cash receipt or payment?
- a. Classified in its entirety based on the predominant source of the cash flows as an operating, investing, or financing activity.
 - b. Classified as separate components of a single transaction where each component is classified as an operating, investing, or financing activity.
 - c. Disclosed in a supplementary schedule.
 - d. Disclosed as an operating activity.
12. Given certain circumstances, how does IFRS allow bank overdrafts to be considered?
- a. As cash equivalents.
 - b. As investing activities.
 - c. As operating activities.
 - d. As financing activities.

Chapter 3: Property, Plant and Equipment, and Lease Accounting

Introduction

This chapter discusses the differences in U.S. GAAP and IFRS in accounting for property, plant and equipment, and leases.

Learning Objectives

Completion of this chapter will enable you to:

- Explain the cost used in IFRS and U.S. GAAP for valuing property, plant and equipment and the optional revaluation model used in IFRS.
- Differentiate between types of leases and how to account for the leases under IFRS and U.S. GAAP.

Cost of Property, Plant and Equipment

Under both U.S. GAAP and IFRS, entities initially record property plant and equipment at cost. Cost includes all expenditures necessary to get the asset to the location and in working condition for its intended use. For example:

- Transportation costs,
- Insurance while in transit,
- Installation costs,
- Import duties,
- Costs of site preparation, and
- Costs of employee benefits arising directly from the construction or acquisition of the item of property, plant and equipment.

U.S. GAAP and IFRS require that the costs of dismantling an asset and restoring its site (that is, the costs of asset retirement under FASB ASC 410 (formerly SFAS 143, *Accounting for Asset Retirement Obligations*), or IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*) be included in the cost of the asset. However, neither set of standards allows the capitalization of start-up costs, general administrative and overhead costs, or regular maintenance.

FASB ASC 835 (formerly SFAS 34, *Capitalization of Interest*), and IAS 23, *Borrowing Costs*, address the capitalization of borrowing costs (e.g., interest costs) directly attributable to the acquisition, construction, or production of a qualifying asset. Both sets of GAAP similarly defined qualifying assets; however, while the capitalization of interest is required under U.S. GAAP, it is optional under IFRS.

Cost Subsequent to Acquisition

Entities have a myriad of choices on how to handle the cost of major repairs or overhauls. Under IFRS, costs that represent a replacement of a previously identified component of an asset are capitalized if future economic benefits are probable and the costs can be reliably measured. Under U.S. GAAP, multiple accounting models have evolved in practice, including expensing costs as incurred, and capitalizing costs and amortizing through the date of the next overhaul. Entities may also elect to follow the IFRS approach.

Measurement of Property, Plant and Equipment after Recognition

Under IFRS 16, *Property, Plant and Equipment*, an entity must choose either the cost model or the revaluation model as its accounting policy and the entity must apply that policy to an entire class of property, plant and equipment. The revaluation model is **not** permissible under U.S. GAAP.

Cost Model

After an entity recognizes an item of property, plant and equipment the entity carries the asset at cost less any accumulated depreciation and any accumulated impairment losses. The cost model is the only acceptable method under U.S. GAAP, whereas, IFRS allow an entity to use either the cost model or the revaluation model. **(IAS 16, ¶30)**

Revaluation Model (IFRS Only)

After an entity recognizes an item of property, plant and equipment whose fair value is reliably measurable, the entity will carry the asset at a revalued amount. The revalued amount is the asset's fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. Entities should revalue property, plant and equipment with sufficient regularity to ensure that the carrying amount does not differ materially from the amount the entity would determine using fair value at the end of the reporting period. **(IAS 16, ¶31)**

Determination of Fair Value

For land and buildings, normally a qualified appraiser makes the estimate using market-based evidence. The fair value of plant and equipment is usually an appraisal value. **(IAS 16, ¶32)**

If there is no market fair value because of the specialized nature of the property, plant or equipment and the item is rarely sold, except as part of a continuing business, an entity may need to estimate fair value using an income or a depreciated replacement cost approach.

Frequency of Revaluation

How frequently an entity revalues property, plant and equipment depends upon the volatility of the changes in fair value of the items. When the fair value of a revalued asset materially differs from its carrying value, a revaluation is required. Some items of property, plant and equipment may experience frequent significant and volatile changes in fair value, thus needing annual revaluation. Frequent revaluations are not necessary for items that only have insignificant changes in fair value. Instead, it may be necessary to revalue these items only every three or five years. **(IAS 16, ¶34)**

Accumulated Depreciation at Revaluation

An entity treats any accumulated depreciation on property, plant and equipment at the date of the revaluation in one of the following ways (**IAS 16, ¶35**):

- Proportionately restate with the change in the gross carrying amount of the asset so that the carrying amount of the asset after revaluation equals its revalued amount. Entities typically use this method when using an index to determine the asset's depreciated replacement cost.
- Eliminating accumulated depreciation against the gross carrying amount of the asset and the net amount restated to the revalued amount of the asset. Entities generally use this method for buildings.

Reporting Revaluation Amount

Increase in Carrying Amount. If an asset's carrying amount increases because of a revaluation, the entity recognizes the increase in other comprehensive income and accumulated in equity under the heading of "Revaluation surplus." However, if the entity has previously recognized a revaluation decrease on the same asset in profit or loss, it will recognize the increase in profit or loss to the extent of the previously recognized loss.

Decrease in Carrying Amount. If an asset's carrying amount decreases because of a result of a revaluation, the entity recognizes the decrease in profit or loss. However, if the entity has previously recognized a revaluation increase on the same asset in other comprehensive income, it will recognize the decrease to the extent of any credit balance existing in the "Revaluation surplus" with respect to that asset. The decrease recognized in other comprehensive income reduces the amount accumulated in equity under the heading of revaluation surplus.

For example, M&M Corporation revalues two groups of assets, machinery and motor vehicles, at December 31, 20X1 (the end of its first year of operations). The analysis results in a revaluation increase in machinery of €5,000 and a €8,000 revaluation decrease in motor vehicles.

M&M recognizes the €5,000 increase in machinery in other comprehensive income as a "Revaluation surplus." Whereas, M&M recognizes the €8,000 revaluation decrease in motor vehicles as a revaluation loss in profit and loss.

The revaluation analysis at December 31, 20X2 indicates a €7,000 revaluation decrease on the machinery and a €10,000 revaluation increase in the motor vehicles.

Of the €7,000 revaluation loss on the machinery, M&M recognizes €5,000 as a reduction of the "Revaluation surplus" in comprehensive income (reducing the "Revaluation surplus" to zero) and the remaining €2,000 as a revaluation loss in profit and loss.

M&M recognizes the first €8,000 of the revaluation increase on the motor vehicles in profit and loss and the remaining €2,000 is as "Revaluation surplus" in comprehensive income.

Depreciation of Property, Plant and Equipment

Under U.S. GAAP and IFRS, entities depreciate property, plant and equipment over its useful life. An item is depreciated even if it is idle, but not if it is held for sale.

Under IFRS an entity reviews the estimated useful life, residual value, and the method of depreciation at least at each annual reporting date. An entity may increase or decrease the residual value. Unlike IFRS, under U.S. GAAP entities only review these items when events or changes in circumstances indicate that the current estimates or depreciation method are no longer appropriate. Additionally, under U.S. GAAP the residual value may only be reduced. Under both sets of standards an entity accounts for any changes prospectively as a change in estimate.

IFRS require component depreciation when an item of property, plant and equipment is comprised of individual components for which different depreciation methods or rates are appropriate. Unlike IFRS, U.S. GAAP allows component accounting but does not require it.

Lease Accounting—Part A

The overall accounting for leases under FASB ASC 840 (formerly SFAS 13, *Accounting for Leases*), (as amended) and IAS 17, *Leases* (as amended) is similar, although U.S. GAAP, being rules-based, has more specific rules than IFRS. Both sets of GAAP focus on classifying leases as either operating or capital (IAS 17 uses the term “finance” rather than “capital”), and both separately discuss lessee and lessor accounting.

Lease Classification Criteria

Given the very specific classification criteria found in U.S. GAAP and the additional criteria the lessor must meet, the lessee and the lessor may classify the lease differently. That is, the lessee may classify the lease as a capital lease, while the lessor may account for the lease as an operating lease.

Under IFRS, the guidance focuses on the overall substances of the transaction and there are no additional criteria for the lessor. Thus, under IFRS lease classification by the lessor and the lessee generally should be symmetrical.

U.S. GAAP Classification Criteria

FASB ASC 840 contains four specific criteria for determining whether a lessee will classify a lease as an operating lease or a capital lease. For the lessee to classify the lease as a capital lease, the lease must meet one or more of the following criteria:

- The lease transfers ownership of the property to the lessee by the end of the lease term,
- The lease contains a bargain purchase option,
- The lease term is equal to 75% or more of the estimated economic life of the leased property, or
- The present value of the minimum lease payments is equal to or greater than 90% of the fair value of the leased property at lease inception.

The last two criteria are not applicable if the beginning of the lease term is within the last 25% of the total estimated economic life of the leased property, including earlier years of use.

For the lessor to classify a lease as a capital lease the lease agreement must meet at least one of the four preceding criteria and two additional criteria (**FASB ASC 840-10-25**):

- Collectibility of the minimum lease payments is reasonably predictable, and
- No important uncertainties surround the amount of unreimbursable costs yet to be incurred by the lessor under the lease.

Assuming a lessor classifies a lease as a capital lease, it will classify the lease as either a sales-type lease or a direct financing lease.

IFRS Classification Criteria

Under IAS 17, an entity classifies a lease as a finance lease if the lease transfers **substantially all** the risks and rewards incidental to ownership. An entity accounts for a lease as an operating lease if the lease does not transfer **substantially all** the risks and rewards incidental to ownership.

Unlike U.S. GAAP, a lessor does not classify a finance lease as a sales-type or a direct financing lease. Both lessee and lessor classify a lease as a finance lease or an operating lease.

IAS 17 provides examples of conditions or indicators that could lead to an entity classifying a lease as a finance lease. These conditions or indicators include (**IAS 17, ¶10–11**):

- The lease transfers ownership of the asset to the lessee by the end of the lease term,
- The lessee has the option to purchase the asset at a price that is expected to be sufficiently lower than the fair value at the date the option becomes exercisable for it to be reasonably certain, at the inception of the lease, that the option will be exercised,
- The lease term is for the major part of the economic life of the asset even if title is not transferred,
- At the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset,
- The leased assets are of such a specialized nature that only the lessee can use them without major modifications,
- If the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee,
- Gains or losses from the fluctuation in the fair value of the residual accrue to the lessee (for example, in the form of a rent rebate equaling most of the sales proceeds at the end of the lease), and
- The lessee has the ability to continue the lease for a secondary period at a rent that is substantially lower than market rent.

Lessee's Recognition of a Finance (Capital) Lease

The initial recognition of a finance (capital) lease is the same under IFRS and U.S. GAAP. At the beginning of the lease term, the lessee recognizes a finance (capital) lease as an asset and liability in its balance sheet at an amount equal to the present value of the minimum lease payments. However, if the present value of the minimum lease payments exceeds the fair value of the leased property, the entity records the asset and liability at the fair value of the asset.

The lessee adds any initial direct costs to the amount recognized as an asset.

Discount Rate for Calculating Present Value

U.S. GAAP: The lessee computes the present value of the minimum lease payments using its incremental borrowing rate, unless (a) the lessee can practicably learn the implicit rate used by the lessor and (ii) the implicit rate used by the lessor is less than the lessee's incremental borrowing rate. If the lessee can meet both of these conditions, then the lessee uses the implicit rate.

IFRS: The discount rate to be used in calculating the present value of the minimum lease payments is the interest rate implicit in the lease, if this is practicable to determine; if not, the lessee's incremental borrowing rate shall be used. Unlike U.S. GAAP, IAS 17 **does not** require that the implicit rate be lower than the lessee's incremental borrowing for the lessee to use the lessor's implicit rate. If the lessee can practicably determine the implicit rate, it must use the implicit rate.

Subsequent Measurement

The lessee will allocate the minimum lease payments between the interest charge and the reduction of the outstanding liability. The lessee uses the interest method of amortization so that the interest charge allocated to each period will produce a constant periodic rate of interest on the remaining balance of the liability. Any contingent rents are recognized as expenses in the periods in which they are incurred.

For depreciable assets, the lessee must recognize depreciation expense each accounting period. The lessee uses a depreciation policy consistent with that for depreciable assets it owns, and calculates depreciation in accordance with IAS 16, *Property, Plant and Equipment* and IAS 38, *Intangible Assets*.

If there is no reasonable certainty that the lessee will obtain ownership of the asset at the end of the lease term, the lessee will depreciate the asset over the shorter of the lease term or its useful life.

Lessor's Initial Recognition of a Finance (Capital) Lease

IAS 17 requires the lessor to recognize an asset held under a finance lease in its statement of financial position and present it as a receivable at an amount equal to the net investment in the lease.

FASB ASC 840 requires the lessor to classify a lease as either a sales-type lease or direct financing lease. Regardless of the lessor's classification of the capital lease, the lessor recognizes its gross investment in the lease as an asset (receivable). The lessor recognizes the difference between the lessor's gross investment in the lease and the lessor's net investment in the lease as unearned revenue.

This course does not include a discussion of the technical aspects of sales-type leases and direct financing leases because they do not exist under IFRS.

Land and Building Leases

U.S. GAAP

U.S. GAAP contains detailed rules on accounting for real estate leases. The rules for the lessee and lessor vary depending on:

- Whether the lease is for land; land and building; land, building, and equipment; or part of a building,
- Which, if any, of the lease classification criteria are met,
- The proportional relationship between the fair value of the land and the fair value of the building,
- Whether the lease is a sales-type or direct financing lease

Generally, the lessor and the lessee will account for the land and building as a single unit, unless value of the land is material (i.e., the fair value of the land represents 25% or more of the total fair value of the leased property).

IFRS

Because IFRS are principle-based standards, the accounting for land and building leases is less defined. When a lease includes both land and building elements, an entity assesses the classification of each element as a finance lease or operating lease separately. When determining if the land element is an operating lease or a finance lease, remember that normally land has an indefinite economic life.

If the lessee and the lessor separate out the land element, unless they expect title to pass to the lessee by the end of the lease term, they would normally classify the land as an operating lease. The lessee and the lessor classify the building as either a finance or operating lease based on the lease terms.

If the lessee classifies the land and building as an investment property in accordance with IAS 40, *Investment Property*, and the lessee adopts the fair value model, separate measurement of the land and building elements is not required.

Sale-Leaseback Transactions

Differences in the context of U.S. GAAP and IFRS may lead to differences in the timing of gain recognition in sale-leaseback transactions. Where differences exist, IFRS usually lead to recognizing the gain before U.S. GAAP.

U.S. GAAP

FASB ASC 840 requires that if the seller-lessee leases back substantially all of the asset, the seller-lessee will defer any gain or loss on the sale-leaseback transaction and amortize the gain or loss over the lease term. The seller-lessee amortizes the gain or loss in proportion to the amortization of the leased asset, if a capital lease, or in proportion to the related gross rental charged to expense over the lease term, if an operating lease.

Immediate recognition of the full gain is appropriate only when the leaseback is minor. (A leaseback is minor if the present value of a reasonable amount of rental for the leaseback represents 10% or less of the fair value of the asset sold.)

If the portion of the asset leased back were more than minor, but less than substantially all then the seller-lessee would recognize a portion of the gain and defer the remainder.

IFRS

According to IAS 17, when a sale-leaseback transaction results in a lease classified as an operating lease, the seller-lessee recognizes the full gain on the sale if the sale is at the fair value of the asset. The leaseback need not be minor, as under U.S. GAAP.

If the sale price is below fair value, the seller-lessee recognizes any profit or loss immediately, unless the seller-lessee agreed to the favorable sales price in order to make future lease payments at below-market rates, the seller-lessee defers the impact and amortizes the deferred amount in proportion to the lease payments over the lease period. If the sales price is above fair value, the seller-lessee defers and amortizes the excess over the period for which it expects to use the asset.

When a sale-leaseback transaction results in a finance lease, the seller-lessee amortizes the gain or loss over the lease term irrespective of whether the lessee will reacquire the leased property.

Operating Leases

Under both FASB ASC 840 and IAS 17, the lessee and lessor will recognize rental expense and income on an operating lease over the lease term as it becomes payable. If the lessee does not make rental payments on a straight-line basis, it still recognizes rental expense on a straight-line basis unless another systematic and rational basis is more representative of the time pattern in which benefit is derived from the leased property, in which case the lessee and lessor would use that basis. For example, suppose a 12-month lease requires eleven monthly payments of \$12,000 (a total of \$132,000) and no payment the twelfth month. The lessee would recognize \$11,000 ($\$132,000 \div 12$ months) of rent expense each month and the lessor would recognize \$11,000 of rent revenue.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Under the revaluation model, an entity revalues an asset:
- At the asset's cost less any accumulated depreciation.
 - At the assets fair value at the date of the revaluation.
 - The determination of value is based on the historical amount paid for the asset.
 - Only if it decreases in value.
16. In accordance with IAS 16, *Property, Plant and Equipment*, in 20X1 McBride Corporation recognized a €25,000 revaluation increase in the value of the land. At the end of the 20X2 annual reporting period, McBride recognizes a €40,000 revaluation decrease in the value of the land. How would the €40,000 be reported in the December 31, 20X2 financial statements?
- McBride would report the €40,000 loss in profit and loss.
 - McBride would report the €40,000 loss in comprehensive income.
 - McBride would report a portion of the revaluation loss in comprehensive income and a portion in profit and loss.
17. Under U.S. GAAP, which of the following criteria must a lessor meet to classify the lease as a capital lease?
- The lease contains a bargain purchase option.
 - The ownership of the property transfers to the lessee by the end of the lease term.
 - The minimum lease payment is reasonably predictable and collectable.
 - The estimated economic life of the leased property is equal to 75% or more of the lease term.
 - The unreimbursable costs yet to be incurred by the lessor under the lease are not uncertain.
- i, ii, and iv.
 - i, ii, and iii.
 - i, iii, and v.
18. If the lessee leases the land and building and classifies the land and building as investment property in accordance with IAS 40, the lessee must:
- Adopt the fair value model and separately measure the land and building elements.
 - Separate measurement of the land and building elements is not required if the lessee adopts the fair value model.
 - Classify the land and building lease as an operating lease.

19. How are sale-leaseback transactions recognized under IFRS?

- a. If the sale-leaseback transaction is classified as an operating lease, the full gain on the sale is recognized at the fair value of the asset.
- b. The sale-leaseback must be substantial and the seller-lessee will defer any gain or loss on the sale-leaseback transaction.
- c. If the leaseback is only minor, then immediate recognition of the full gain is appropriate. The full gain would not be immediately recognized if the leaseback was major.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

15. Under the revaluation model, an entity revalues an asset: **(Page 44)**

- a. At the asset's cost less any accumulated depreciation. [This answer is incorrect. An entity would revalue an asset at cost less any accumulated depreciation under the cost method. The cost method is only acceptable under U.S. GAAP, but IFRS allows an entity to use the cost model or the revaluation model.]
- b. At the asset's fair value at the date of the revaluation. [This answer is correct. Under IAS 16, if an entity revalues property, plant and equipment whose fair value is reliably measurable, the entity will carry the asset at the revalued amount. The revalued amount is the asset's fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses.]**
- c. The determination of value is based on the historical amount paid for the asset. [This answer is incorrect. The determination of value of an asset when being revalued is based on market-based evidence rendering an appraised value to achieve the fair value of the asset.]
- d. Only if it decreases in value. [This answer is incorrect. If an entity is using the revaluation model, both increases and decreases in value are recognized.]

16. In accordance with IAS 16, *Property, Plant and Equipment*, in 20X1 McBride Corporation recognized a €25,000 revaluation increase in the value of the land. At the end of the 20X2 annual reporting period, McBride recognizes a €40,000 revaluation decrease in the value of the land. How would the €40,000 be reported in the December 31, 20X2 financial statements? **(Page 45)**

- a. McBride would report the €40,000 loss in profit and loss. [This answer is incorrect. While McBride may report a portion of the €40,000 in profit and loss, the entire €40,000 would not be recognized in profit and loss.]
- b. McBride would report the €40,000 loss in comprehensive income. [This answer is incorrect. While McBride may report a portion of the €40,000 in comprehensive income, the entire €40,000 would not be recognized in comprehensive income.]
- c. McBride would report a portion of the revaluation loss in comprehensive income and a portion in profit and loss. [This answer is correct. While McBride would report €25,000 in comprehensive income as a reduction of the "Revaluation surplus," recognized in 20X1, the remaining €15,000 revaluation loss would be recognized in profit and loss for 20X2.]**

17. Under U.S. GAAP, which of the following criteria must a lessor meet to classify the lease as a capital lease? **(Page 47)**
- i. The lease contains a bargain purchase option.
 - ii. The ownership of the property transfers to the lessee by the end of the lease term.
 - iii. The minimum lease payment is reasonably predictable and collectable.
 - iv. The estimated economic life of the leased property is equal to 75% or more of the lease term.
 - v. The unreimbursable costs yet to be incurred by the lessor under the lease are not uncertain.
- a. i, ii, and iv. [This answer is incorrect. These are criteria that the lease must meet for the lessee, not the lessor to classify the lease as a capital lease.]
 - b. i, ii, and iii. [This answer is incorrect. This answer only contains one of the two criteria that the lessor must meet to qualify the lease as a capital lease.]
 - c. **i, iii, and v. [This answer is correct. The lessor must meet the criteria listed in iii and v *plus* one of the criteria from the list that the lessee must meet to qualify the lease as a capital lease. Choice i is one of the four criteria that a lessee must meet.]**
18. If the lessee leases the land and building, and classifies the land and building as investment property in accordance with IAS 40, the lessee must: **(Page 49)**
- a. Adopt the fair value model and separately measure the land and building elements. [This answer is incorrect. Adoption of the fair value model is not mandatory and the lessee has the option to adopt or not.]
 - b. **Separate measurement of the land and building elements is not required if the lessee adopts the fair value model. [This answer is correct. If the lessee classifies the land and building as an investment property in accordance with IAS 40, *Investment Property*, and the lessee adopts the fair value model, separate measurement of the land and building elements are not required.]**
 - c. Classify the land and building lease as an operating lease. [This answer is not correct. To classify the land and building as an investment, the lease must qualify as a finance lease.]
19. How are sale-leaseback transactions recognized under IFRS? **(Page 50)**
- a. **If the sale-leaseback transaction is classified as an operating lease, the full gain on the sale is recognized at the fair value of the asset. [This answer is correct. Under IAS 17, if the sale-leaseback transaction results in a lease classified as an operating lease, the full gain on the sale is recognized at the fair value of the asset. The leaseback need not be minor, as under U.S. GAAP.]**
 - b. The sale-leaseback must be substantial and the seller-lessee will defer any gain or loss on the sale-leaseback transaction. [This answer is incorrect. SFAS 13 requires that if the seller-lessee leases back substantially all of the asset, the seller-lessee will defer any gain or loss on the sale of the sale-leaseback transaction under U.S. GAAP.]
 - c. If the leaseback is only minor, then immediate recognition of the full gain is appropriate. The full gain would not be immediately recognized if the leaseback was major. [This answer is incorrect. The immediate recognition of the full gain of a minor leaseback would be appropriate for U.S. GAAP, but is not for IFRS. Under IFRS, the leaseback need not be minor.]

EXAMINATION FOR CPE CREDIT

Chapter 3

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

13. Which one of the following is **not** a component of property, plant and equipment?
- a. Import duties.
 - b. Administration and other general overhead costs.
 - c. Costs of employee benefits arising directly from the construction or acquisition.
 - d. Installation costs.
14. In accordance with IAS 16, *Property, Plant and Equipment*, in 20X1 Underwood Corporation recognized a €10,000 revaluation decrease in the value of the land. How would the €10,000 be reported in the December 31, 20X1 financial statements?
- a. As a revaluation allowance in comprehensive income.
 - b. As an extraordinary item in profit and loss.
 - c. €5,000 would be reported as revaluation allowance in comprehensive income and €5,000 would be reported as a loss in profit and loss.
 - d. As a loss in profit and loss.
15. Assuming the lessee can practicably determine the lessor's implicit rate, according to IAS 17, which interest rate would the lessee use to calculate the present value of the minimum lease payments?
- a. The lower of the lessee's incremental borrowing rate or the lessor's implicit rate.
 - b. The higher of the lessee's incremental borrowing rate or the lessor's implicit rate.
 - c. The incremental borrowing rate.
 - d. The implicit rate.
16. Under IAS 17, the lessee:
- a. Estimates contingent rents at lease inception and includes them in the minimum lease payments.
 - b. Adjusts the minimum lease payments for the amount of contingent rents earned during the period.
 - c. Recognizes contingent rents as expense when incurred.
 - d. Estimates contingent rents at lease inception and recognizes them in rent expense equally over the lease term.

17. Under IAS 17, *Leases*, when a sale-leaseback transaction results in a finance lease, how does the seller-lessee recognize gains and losses?
- a. Recognizes gains immediately and losses over the lease term.
 - b. Recognizes both gains and losses immediately.
 - c. Amortizes both gains and losses over the lease term.
 - d. Recognizes losses immediately and gains over the lease term.

Chapter 4: Intangible Assets, Impairments, Non-current Assets Held for Sale and Discontinued Operations

Introduction

This chapter continues the discussion of long-lived assets. This chapter discusses intangible assets, recognition of impairments on tangible and intangible assets, and the reporting of non-current assets held for sale and discontinued operations.

Learning Objectives

Completion of this chapter will enable you to:

- Describe the differences between U.S. GAAP and IFRS in the accounting for various intangible assets and contrast impairment tests under both standards.
- Discuss the differences in reporting discontinued operations between U.S. GAAP and IFRS.

Intangible Assets

Definition of Intangible Assets

U.S. GAAP and IFRS similarly define *intangible assets* as identifiable non-monetary assets that lack physical substance. As used in the two Boards' pronouncements the term intangible asset is used to include all intangible assets other than goodwill. While in the broad sense goodwill is an intangible asset, in the standards, the term *intangible assets* excludes goodwill. An intangible asset is identifiable if it is separable or arises from contractual or legal rights. The definition of an intangible asset requires an intangible asset to be identifiable. This requirement distinguishes goodwill from other intangible assets. Examples of intangible assets, as the term is used in the standards, are:

- Customer lists
- Broadcast licenses
- Airline routes
- Trademarks

Goodwill

An entity only recognizes goodwill in a business combination and goodwill is measured as a residual. When an entity recognizes goodwill in a business combination, it is recognizing an asset that represents the future economic benefits arising from other assets acquired in the combination that are not individually identified and separately recognizable. The future economic benefits may be the result of synergy between the identifiable assets acquired or from unidentifiable assets.

Research and Development Costs

Research Costs

FASB ASC 730 (formerly SFAS 2, *Accounting for Research and Development Costs*), and IASB 38, *Intangible Assets*, similarly define research. FASB ASC 730-10-20 defines research as “planned search or critical investigation aimed at discovery of new knowledge with the hope that such knowledge will be useful in developing a new product or service or a new process or technique or in bringing about a significant improvement to an existing product or process.”

IASB 38 defines research as “original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.” (**IASB 38, ¶8**)

Under both standards, entities generally expense research costs as incurred.

Development Costs

U.S. GAAP prohibits, with very limited exceptions, the capitalization of development costs. IFRS allows the capitalization of development costs if certain criteria are met. Additional differences exist in accounting for software development costs; U.S. GAAP provides specific detailed guidance depending on whether the software is for internal use or for sale. The principles surrounding capitalization under IFRS are the same whether the internally generated intangible is developed for internal use or for sale.

U.S. GAAP: FASB ASC 730-10-20 defines development as “the translation of research findings or other knowledge into a plan or design for a new product or process or for a significant improvement to an existing product or process whether intended for sale or use.” Development costs are expensed as incurred unless another standard permits capitalization.

For example, FASB ASC 985 (formerly SFAS 86, *Accounting for the Costs of Computer Software to Be Sold, Leased, or Otherwise Marketed*), allows capitalization of development costs related to computer software developed for external use once technological feasibility is established. For software developed for internal use, an entity may only capitalize those costs incurred during the application development stage. (**FASB ASC 350-40-25**)

IFRS: IASB 38 defines development as “the application of research findings or other knowledge to a plan or design for the production of new or substantially improved materials, devices, products, processes, systems or services before the start of commercial production or use.” (**IASB 38, ¶8**)

Unlike U.S. GAAP, IFRS allow an entity to capitalize development costs when the entity can demonstrate the technical and economic feasibility of a project in accordance with specific criteria. To capitalize development costs an entity must demonstrate (**IASB 38, ¶57**):

- The technical feasibility of completing the intangible asset so that it will be available for use or sale.
- Its intention to complete the intangible asset and use or sell it.
- Its ability to use or sell the intangible asset.

- How the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.
- The availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.
- Its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Direct-response Advertising

IASB 38 has no special requirement for direct-response advertising and any expenditure is expensed as incurred. However, U.S. GAAP in FASB ASC 340-20-25 (formerly SOP 93-07, *Reporting on Advertising Costs*), allows an entity to capitalize the cost of direct-response advertising if both of the following conditions are met:

- The primary purpose is to make sales to customers that have responded specifically to that advertising; and
- There is credible evidence, including historical patterns, indicating that the advertising will result in probable future economic benefits.

The capitalized costs are amortized *pro rata* to the related revenue recognition.

Subsequent Expenditures

Under IAS 38, a subsequent expenditure on an intangible asset may be capitalized if the expenditure meets:

- The definition of an intangible asset, and
- The recognition criteria for intangible assets.

Under FASB ASC 730, an entity may capitalize a subsequent expenditure on an intangible asset if the expenditure increases the utility of the asset. While the wording of the IAS 38 and FASB ASC 730 differs, in practice they probably will result in the same treatment of subsequent expenditures.

Revaluation of Intangibles (other than Goodwill)

IAS 38 permits the revaluation of intangibles (other than goodwill) to fair value only when there is an active market. An active market exists when:

- The items traded are homogenous,
- Willing buyers and sellers normally can be found at any time, and
- Prices are available to the public.

Because revaluation requires referencing an active market for the specific type of intangible, revaluation is uncommon in practice. However, if an entity revalues an intangible, it must revalue all the intangibles in that class, to the extent there is an active market, and the revaluations must be kept up-to-date.

U.S. GAAP does not permit the revaluation of intangible assets.

Impairment of Assets

Long-lived Assets

Nearly all current and non-current assets are subject to impairment testing to ensure that an entity does not overstate them in the statement of financial position. The guidance under U.S. GAAP FASB ASC 360, and IAS 36, *Impairment of Assets*, as they relate to nonfinancial assets (e.g., intangibles; property, plant and equipment; inventory; and investment property) have several prominent differences that potentially have extensive implications.

FASB ASC 360 and IAS 36 apply to most long-lived and intangible assets, although some of the scope exceptions listed in the standards differ. Despite the similarity in overall objectives, differences exist in the way in which entities review, recognize, and measure, impairment.

Differences in Impairment Testing

Differences in the testing for the potential impairment of long-lived assets held for use may lead to earlier impairment recognition under IAS 36 than FASB ASC 360. IFRS require the use of entity-specific **discounted** future cash flows or a fair value measure in tests for the recoverability of an asset. By comparison, U.S. GAAP uses a two-step approach that starts with **undiscounted** future cash flows. This basic variation in the impairment models can make a difference between an asset being impaired or not. Additionally, while similar, differences exist as to what qualifies as an impairment indicator and, more importantly, how recoveries in value of previously impaired assets are treated.

Impairment Indicators

U.S. GAAP requires a review for impairment whenever events or circumstances change indicating that the carrying amount of an asset may not be recoverable. IFRS requires a review for impairment indicators at each reporting date. IFRS requires that certain assets (goodwill, indefinite lived intangible assets and intangible assets that are not yet available for use) be tested annually for impairment even if there is no impairment indicator. Like IFRS, U.S. GAAP requires annual impairment testing for goodwill and indefinite lived intangible assets; however, it differs on intangible assets that are not yet available for use requiring impairment testing only if there is an indicator of impairment.

An entity must consider both internal and external indicators when deciding whether an asset is impaired. Examples of external indicators are **(IAS 36, ¶12, and FASB ASC 360-10-35)**:

- Significant adverse changes in the technological, market, economic or legal environment,
- Increases in market interest rates,
- An asset's market value has declined significantly more than would be expected because of the passage of time or normal use, or
- A significant adverse change in legal factors or in the business climate that could affect the value of a long-lived asset (asset group), including an adverse action or assessment by a regulator

Examples of internal indicators are:

- Evidence of obsolescence or physical damage of an asset,
- Evidence from internal reporting that the economic performance of an asset is, or will be, worse than expected, or
- Significant changes with an adverse effect on the entity have taken place during the period, or are expected to take place in the near future, in the extent to which, or manner in which, an asset is used or is expected to be used.

IFRS 36 One-step Approach to Impairment

Whenever possible an entity individually tests assets for impairment. If this is not possible, an entity will test an asset for impairment in cash generating units (CGUs). A CGU is the smallest group of assets that generates cash inflows from continuing use that are largely independent of the cash inflows of other assets or groups of assets.

Under the IFRS one-step approach, an entity compares the carrying amount of an asset (or CGU) with its recoverable amount. The recoverable amount is the higher of (a) the asset's fair value less costs to sell or (b) the asset's value in use (net present value of future cash flows).

FASB ASC 360 Two-step Approach to Impairment

Unlike IFRS, an entity recognizes an impairment loss for assets (other than goodwill and identifiable intangibles with indefinite lives) only if the asset's carrying amount is less than the undiscounted cash flows of the asset. Thus, the first step is to compare the **undiscounted** future cash flows to the carrying amount of the asset. If the carrying amount is greater than the undiscounted cash flows, there is no impairment loss and no need to proceed to the second step.

The second step is measuring the amount of the impairment loss. The impairment loss is the difference between the carrying amount of the asset and the asset's fair value. FASB ASC 820 (formerly SFAS 157, *Fair Value Measurements*), states that for long-lived assets that have uncertainties both in timing and amount, an expected present value technique often is the appropriate technique to estimate fair value (**FASB ASC 820, ¶E24(b)**).

Example: RMM Company has machinery that cost €1,500,000 and has a book value of €1,200,000. The current fair value of the machinery is €800,000. The expected future cash flows (undiscounted) attributable to the machinery are €1,300,000. What is the amount of the impairment loss under U.S. GAAP and IFRS?

According to the two-step impairment test in FASB ASC 360, RMM will not recognize an impairment loss on the machinery. The first step of the impairment test is to compare the undiscounted future cash flows attributable to the machinery (€1,300,000) to the book value of the machinery (€1,200,000). Because the undiscounted future cash flows are greater than the book value of the asset, the asset is not considered impaired under FASB ASC 360.

IFRS 36 has a one-step impairment test—comparing the fair value of the machinery to its book value. Because the asset's fair value (€800,000) is less than its book value (€1,200,000), RMM will recognize a €400,000 impairment loss under IFRS.

Goodwill Impairment

IAS 36 and FASB ASC 350 (formerly SFAS 142, *Goodwill and Other Intangible Assets*), require annual impairment testing for goodwill and intangible assets that have an indefinite life. Additionally, IAS 36 requires annual testing for intangible assets not yet available for use, whereas, FASB ASC 350 only requires those intangibles to be tested if there is an indicator of impairment. Both U.S. GAAP and IFRS allow an entity to perform the test any time during the annual reporting period, just so it performs the test at the same time each year.

Both U.S. GAAP and IFRS *require* an entity to gross up the carrying amount of goodwill for impairment testing if non-controlling interests exist.

IFRS 36 One-step Approach to Goodwill Impairment

Because goodwill does not directly generate cash flows, an entity cannot test it for impairment like other long-lived assets (e.g., equipment or land). Therefore, an entity must test for goodwill impairment loss at the CGU level—for goodwill, this is the lowest level at which internal management monitors goodwill. This level cannot be larger than an operating segment. An entity will allocate goodwill to CGUs or groups of CGUs that will benefit (or are expected to benefit) from the synergies of the business combination from which the goodwill arose.

If the CGU's carrying amount, including goodwill, exceeds its recoverable amount, the difference is first allocated to reduce goodwill to zero, then the carrying amount of other assets in the CGU are reduced pro rata, based on the carrying amount of each asset.

SFAS 142 Two-step Approach to Goodwill Impairment

Unlike IAS 36, FASB ASC 350 allocates goodwill to reporting units that will benefit (or are expected to benefit) from the synergies of the business combination in which the goodwill arose. Unlike a CGU, a reporting unit is an operating segment or one level below an operating segment.

The U.S. GAAP two-step approach requires an entity to perform a recoverability test first at the reporting unit level (comparing the carrying amount of the reporting unit to the reporting unit fair value). If the fair value of the reporting unit is less than its carrying an impairment loss is calculated.

The impairment loss is the amount by which the carrying amount of goodwill exceeds the implied fair value of the goodwill within the reporting unit.

Example—No Impairment Loss under U.S. GAAP, Impairment Loss under IFRS

RMM Company is conducting an impairment review on BEM, one of its reporting units. At the time of the impairment test, RMM assesses the overall current fair value for the entire BEM unit at \$600,000. The table below shows the FMV of the assets and liabilities. From these amounts, the implied goodwill of \$175,000 is the difference between the overall carrying value and the current FMV of the net assets (\$600,000 – \$425,000).

	Carrying Value	Current Fair Value
Tangible Assets	\$250,000	\$255,000
Patents	240,000	200,000
Goodwill	150,000	?
Liabilities	(30,000)	(30,000)

GAAP: Step 1 compares the current fair value of \$600,000 to the carrying value of \$610,000. Since the fair value is less than the carrying value step 2 is required. For step 2 implied goodwill of \$175,000 is compared to the carrying value of goodwill \$150,000. Because the implied fair value of goodwill is more than the carrying value of goodwill RMM does not recognize a goodwill impairment loss.

IFRS: To keep this relatively simple, assume the current fair value of \$600,000 meets the definition of recoverable amount value under IFRS. RMM recognizes an impairment loss since the carrying value of \$610,000 exceeds the recoverable amount by \$10,000. In this case, the impairment loss would reduce the carrying value of goodwill from \$150,000 to \$140,000.

Example—Impairment Loss under GAAP and IFRS

RMM Company is conducting an impairment review on JLS, one of its reporting units. At the time of the impairment test, RMM assesses the overall current fair value for the entire JLS unit at \$470,000. The table below shows the FMV of the assets and liabilities. From these amounts, the implied goodwill of \$80,000 is the difference between the overall carrying value and the current FMV of the net assets (\$470,000 – \$390,000).

	Carrying Value	Current Fair Value
Tangible Assets	\$220,000	\$240,000
Patents	180,000	190,000
Goodwill	125,000	?
Liabilities	(40,000)	(40,000)

GAAP: Step 1 compares the current fair value of \$470,000 to the carrying value of \$485,000. Since the fair value is less than the carrying value step 2 is required. For step 2 implied goodwill of \$80,000 is compared to the carrying value of goodwill \$125,000. Because the implied fair value of goodwill is less than the carrying value of goodwill, RMM recognizes an impairment loss of \$45,000, reducing the carrying value of the goodwill to \$80,000.

IFRS: To keep this relatively simple, assume the current fair value of \$470,000 meets the definition of recoverable amount value under IFRS. RMM recognizes an impairment loss since the carrying value of \$470,000 exceeds the recoverable amount by \$15,000. In this case, the impairment loss reduces the carrying value of goodwill from \$125,000 to \$110,000.

Indefinite Life Intangible Assets

Both IFRS 36 and FASB ASC 350 have similar impairment tests for indefinite life intangible assets. IFRS 36 requires a comparison of the assets carrying value to its recoverable amount. If the carrying value is greater, an impairment loss is recognized.

The FASB ASC 350 impairment test consists of comparing the fair value of the intangible asset to its carrying value. If the carrying value exceeds the fair value, the entity recognizes an impairment loss equal to that excess.

Therefore, the only difference is that IAS 36 uses the intangible asset's recoverable value and FASB ASC 350 uses the asset's fair value.

Recognition of Impairment Loss

IFRS 36 requires immediate recognition of an impairment loss in profit or loss, unless the entity has revalued the asset upward in accordance with another standard (for example, in accordance with the revaluation model in IAS 16, *Property, Plant and Equipment*). The entity recognizes the impairment loss on a revalued asset in other comprehensive income to the extent that the impairment loss does not exceed the amount in the revaluation surplus for that same asset. Once the impairment loss reduces the revaluation surplus to zero, the entity recognizes any remaining impairment loss in profit or loss.

FASB ASC 350 requires an entity to recognize any impairment loss in income from continuing operations.

Reversals of Impairment Losses

IAS 36 allows for the recognition of reversals of impairment losses on all assets except goodwill. U.S. GAAP prohibits the recognition of impairment loss reversals.

Non-current Assets Held for Sale

IFRS 5, *Non-current Assets Held for Sale and Discontinued Operations*, requires an entity to classify a non-current asset (or disposal group) as held for sale if it expects to recover the carrying value primarily through a sale rather than through continuing use. While FASB ASC 360 (formerly SFAS 144, *Accounting for the Impairment or Disposal of Long-Lived Assets*), does not have this explicit verbiage, both standards have the same criteria for an entity to meet to classify long-lived assets as held for sale.

Classification Criteria

The classification criteria of the standards are **(FASB ASC 360-10-4 and IFRS 5, ¶6–8)**:

- The appropriate level of management commits to a plan to sell the asset (disposal group),
- The asset (disposal group) is available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets,
- An active program to locate a buyer and other actions required to complete the plan have been initiated,

- The sale of the asset (disposal group) is probable, and transfer of the asset (disposal group) is expected to qualify for recognition as a completed sale, within one year from the date of classification,
- The asset (disposal group) is being actively marketed for sale at a price that is reasonable in relation to its current fair value, and
- Actions required to complete the plan indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn.

Measurement of Non-current Assets (Disposal Group) Held for Sale

The measurement of non-current assets (disposal group) held for sale is the same under IFRS 5 and FASB ASC 360. Both sets of standards require an entity to measure a non-current asset (disposal group) classified as held for sale at the lower of its carrying amount and fair value less costs to sell.

An entity does not depreciate (amortize) a non-current asset classified as held for sale. However, the entity must continue to accrue any interest and other expenses attributable to the liabilities of a disposal group classified as held for sale.

An entity will recognize a loss for any initial or subsequent write-down to fair value less costs to sell. An entity may recognize a gain for any subsequent increase in fair value less costs to sell, but not in excess of the cumulative loss previously recognized. The gain or loss is an adjustment of the carrying amount of a non-current asset (disposal group).

A gain or loss not previously recognized resulting from the sale of a long-lived asset (disposal group) is recognized at the date of sale.

What Constitutes a Discontinued Operation?

IFRS 5 has a narrower definition for classifying a component of an entity as a discontinued operation than FASB ASC 360.

Both standards use the same definition for a component of an entity, “a component of an entity comprises operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the rest of the entity.” **(FASB ASC 205-10-20 and IFRS 5, ¶31)**

Where the standards differ is in what components qualify for reporting as discontinued operations.

Under IFRS 5, a discontinued operation is a component of an entity that either has been disposed of, or is classified as held for sale, and

- Represents a separate major line of business or geographical area of operations,
- Is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or
- Is a subsidiary acquired exclusively with a view to resale.

According to FASB ASC 360, a component of an entity may be:

- A reportable segment,
- An operating segment,
- A reporting unit,
- A subsidiary, or
- An asset group.

Additionally, under U.S. GAAP the entity **may not** have significant continuing involvement in the operations of the component's operations after disposal. IFRS does not prohibit significant continuing involvement in the operations of the component's operations after disposal.

The more narrow definition of what an entity can classify as a component under IFRS 5 would probably reduce the number of disposals that are reportable as discontinued operations.

Partial Disposals

Under IFRS 5, a partial disposal characterized by moving from a controlling to a noncontrolling interest could qualify as a discontinued operation. However, under FASB ASC 360, this would not qualify as a discontinued operation because of the continuing involvement.

Non-current Assets Held for Sale

Both IFRS 5 and FASB ASC 360 require an entity to separately report information about a non-current asset (disposal group) held for sale from other assets in the statement of financial position. However, the standards do not require re-presenting the comparative statement of financial position when a non-current asset (disposal group) is classified as held for sale.

An entity will separately disclose the liabilities of a disposal group classified as held for sale from other liabilities in the statement of financial position or in the notes to the financial statements. The standards **do not** allow offsetting these assets and liabilities and presenting them as a single amount. **(FASB ASC 360, and IFRS 5, ¶38)**

Additionally the standards require the following disclosures in the notes to the financial statements in the period in which a non-current asset (disposal group) is classified as either held for sale or is sold:

- A description of the non-current asset (disposal group),
- A description of the facts and circumstances of the disposal, or leading to the expected disposal, and the expected manner and timing of the disposal,
- The gain or loss recognized and, if not separately presented in the statement of comprehensive income the caption in the statement of comprehensive income that includes that gain or loss, and
- If applicable, the reportable segment in which the non-current asset (disposal group) is presented.

Discontinued Operations

Both IFRS 5 and FASB ASC 360 require an entity to present discontinued operations separately on the face of the income statement. However, unlike IFRS 4, FASB ASC 360 does not require, but permits, separate disclosure of cash flow information for discontinued operations.

Under both sets of standards, an entity must re-present the comparative income statements for discontinued operations. Additionally, under IFRS, an entity must re-present cash flow information for discontinued operations, but not U.S. GAAP, unless the entity presents the information separately for the current period.

If an entity reports discontinued operations, the standards require it to disclose—

- A single amount comprising the total of the:
 - Post-tax profit or loss on discontinued operations, and
 - Post-tax gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operations.
 - An analysis of the single amount in (a) into the:
 - Revenue, expenses, and pre-tax profit or loss on discontinued operation,
 - Related income tax expense (benefit), and
 - Gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.
- (FASB ASC 360 and IFRS 5, ¶33)**

The analysis may be presented in the notes to the financial statement or in the income statement.

Discontinued Operations—Exposure Draft

The IASB issued an exposure draft, *Discontinued Operations*, in September 2008 to amend IFRS 5. The comment period for the exposure draft ended January 23, 2009. The exposure draft proposes amendments to IFRS 5 revising the definition of discontinued operations and requiring additional disclosures related to components of an entity that have been (or will be) disposed of.

In a joint project on financial statement presentation, the IASB and the FASB decided to develop a common definition of discontinued operations and require common disclosures about components of an entity that have been (or will be) disposed of. A final statement is expected to be issued in Q3 of 2010.

The Boards propose that an entity will present a disposal activity as a discontinued operation only when an entity has made a strategic shift in its operations. Additionally, the boards decided that a definition of discontinued operations based on operating segments, as defined in IFRS 8, *Operating Segments*, best captures a strategic shift in the entity's operations, because under IFRS 8 an entity determines operating segments based on how the chief operating decision maker makes decisions about allocating resources and assessing performance.

The IASB has not reconsidered other aspects of IFRS 5.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. IAS 38, *Intangible Assets*, allows the revaluation of intangible assets when an active market exists. Which of the following is **not** a characteristic of an active market?
- a. The items traded are standardized.
 - b. At any time, willing buyers and sellers can be found.
 - c. The seller has entered into a contract to sell the intangible.
 - d. The public has the prices available to them.
21. M&M Company has a building that cost €500,000 and has a book value of €400,000. The current fair value of the building is €350,000. The expected future cash flows (undiscounted) attributable to the building are €425,000 and the net present value is €325,000. What is the amount of the impairment loss under IFRS?
- a. €0.
 - b. €50,000.
 - c. €75,000.
 - d. €100,000.
22. M&M Company has a building that cost €500,000 and has a book value of €400,000. The current fair value of the building is €350,000. The expected future cash flows (undiscounted) attributable to the building are €425,000 and the net present value is €325,000. What is the amount of the impairment loss under GAAP?
- a. €0.
 - b. €50,000.
 - c. €75,000.
 - d. €100,000.
23. For which one of the following assets does IFRS **not** allow a reversal of an impairment loss?
- a. Goodwill.
 - b. Intangibles with indefinite lives.
 - c. Assets such as property, plant and equipment that an entity has revalued upward under the revaluation of IAS 16.
 - d. Intangible assets not yet available for use.

24. Which of the following is **not** a required disclosure if an entity reports discontinued operations?
- a. The revenue, expenses and pre-tax profit or loss of discontinued operations.
 - b. The gross profit arising from the discontinued operation and any related income tax expense.
 - c. The disposal of the assets or disposal group(s) constituting the discontinued operations or the gain or loss recognized on the measurement to fair value less costs to sell.
 - d. The income tax expense (benefit) related to the discontinued operations.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

20. IAS 38, *Intangible Assets*, allows the revaluation of intangible assets when an active market exists. Which of the following is **not** a characteristic of an active market? **(Page 59)**
- a. The items traded are standardized. [This answer is incorrect. For an intangible asset to have an active market, the items being traded must be similar to the intangible assets being revalued.]
 - b. At any time, willing buyers and sellers can be found. [This answer is incorrect. For a market to be considered active, willing buyers and willing sellers must exist.]
 - c. **The seller has entered into a contract to sell the intangible. [This answer is correct. While having a contract to sell the asset may indicate an active market, it is not necessary for the seller to have entered into a contract for there to be an active market.]**
 - d. The public has the prices available to them. [This answer is incorrect. If prices are not available to the public, the market is not considered an active market.]
21. M&M Company has a building that cost €500,000 and has a book value of €400,000. The current fair value of the building is €350,000. The expected future cash flows (undiscounted) attributable to the building are €425,000 and the net present value is €325,000. What is the amount of the impairment loss under U.S. GAAP? **(Page 61)**
- a. **€0. [This answer is correct. Because the undiscounted future cash flows are greater than the book value of the asset, there is no need to go to the second step of the impairment test—comparing fair value to book value.]**
 - b. €50,000. [This answer is incorrect. This is the difference between the fair value of the asset and its book value (second step of the impairment test); however, under U.S. GAAP, this is not the impairment loss in this situation.]
 - c. €75,000. [This answer is incorrect. This is the difference between the undiscounted future cash flows and the cost of the asset and does not represent the impairment loss under U.S. GAAP.]
 - d. €100,000. [This answer is incorrect. This is the difference between the book value of the asset and the assets cost, i.e., the accumulated depreciation, not the impairment loss.]

22. M&M Company has a building that cost €500,000 and has a book value of €400,000. The current fair value of the building is €350,000. The expected future cash flows (undiscounted) attributable to the building are €425,000 and the net present value is €325,000. What is the amount of the impairment loss under IFRS? **(Page 63)**
- a. €0. [This answer is incorrect. Because the recoverable amount of the asset is less than the asset's book value, M&M will recognize an impairment loss under IFRS.]
 - b. **€50,000.** [This answer is correct. This is the difference between the recoverable amount of the asset and its book value—the impairment loss under IFRS. The recoverable amount is the larger of the asset's fair value or the net present value of future cash flows. Remember, IFRS has a one-step test unlike U.S. GAAP which has a two-step test.]
 - c. €75,000. [This answer is incorrect. This is the difference between the undiscounted future cash flows and the cost of the asset. Under IFRS, this is not the calculation of the impairment loss.]
 - d. €100,000. [This answer is incorrect. This is the difference between the book value of the asset and the asset's cost, i.e. the accumulated depreciation, not the impairment loss.]
23. For which one of the following assets does IFRS **not** allow a reversal of an impairment loss? **(Page 64)**
- a. **Goodwill.** [This answer is correct. IAS 36 does not allow for the recognition of reversals of impairment losses on goodwill because even if the specific external event that caused the recognition of the impairment loss is reversed, it will seldom be possible to determine that the effect of that reversal is a corresponding increase in the recoverable amount of the acquired goodwill.]
 - b. Intangibles with indefinite lives. [This answer is incorrect. Even though an intangible asset may have an indefinite life, IAS 36 allows for the recognition of reversals of impairment losses.]
 - c. Assets such as property, plant and equipment that an entity has revalued upward under the revaluation of IAS 16. [This answer is incorrect. IAS 36 allows for the reversal of prior revaluation of assets under the revaluation of assets under the revaluation model of IAS 16.]
 - d. Intangible assets not yet available for use. [This answer is incorrect. Like other intangible assets, IAS 36 requires these intangibles to be reviewed annually for impairment and recovery.]

24. Which of the following is **not** a required disclosure if an entity reports discontinued operations? **(Page 67)**
- a. The revenue, expenses and pre-tax profit or loss of discontinued operations. [This answer is incorrect. FASB ASC 360 and IFRS 5 require an entity to report the revenue, expenses, and pre-tax profit or loss on discontinued operation.]
 - b. The gross profit arising from the discontinued operation and any related income tax expense. [This answer is correct. Neither FASB ASC 360 nor IFRS 5 requires an entity to report the gross profit arising from the discontinued operation and any related income tax expense.]**
 - c. The disposal of the assets or disposal group(s) constituting the discontinued operations or the gain or loss recognized on the measurement to fair value less costs to sell. [This answer is incorrect. Both sets of standards require an entity to disclose the gain or loss recognized on the measurement to fair value less costs to sell or on the disposal of the assets or disposal group(s) constituting the discontinued operation.]
 - d. The income tax expense (benefit) related to the discontinued operations. [This answer is incorrect. Under both FASB ASC 360 and IFRS 5, an entity must report the income tax expense (benefit) related to the discontinued operations.]

EXAMINATION FOR CPE CREDIT

Chapter 4

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

18. IFRS requires a review for impairment indicators for property, plant and equipment:
- a. At each reporting date.
 - b. Annually, but only if there is an impairment indicator.
 - c. Whenever events or circumstances change specifying that the carrying amount of an asset may not be recoverable.
 - d. Do not select this answer choice.
19. CMM Company has a building that cost €1,500,000 and has a book value of €1,100,000. The current fair value of the building is €950,000. The expected future cash flows (undiscounted) attributable to the building are €880,000. What is the amount of the impairment loss under U.S. GAAP?
- a. €0.
 - b. €70,000.
 - c. €150,000.
 - d. €220,000.
20. ESM Company has a building that cost €1,200,000 and has a book value of €900,000. The current fair value of the building is €700,000. The expected future cash flows (undiscounted) attributable to the building are €850,000 and the net present value is €650,000. What is the amount of the impairment loss under IFRS?
- a. €0.
 - b. €50,000.
 - c. €150,000.
 - d. €200,000.
21. Which one of the following may **not** qualify as discontinued operations under FASC ASC 360?
- a. A reportable segment.
 - b. A separate major line of business.
 - c. A reporting unit.
 - d. An asset group.

22. The IASB and the FASB are working on a joint project that will:

- a. No longer allow discontinued operations to be shown as a separate line item on the income statement.
- b. Allow all property, plant and equipment to be valued at the lower of carrying value or fair value less costs to sell.
- c. Develop a common definition of discontinued operations.
- d. Require non-current assets to be disposed of to be valued at an appraised value.

Chapter 5: Accounting for Income Taxes and Share-based Payments

Introduction

This chapter contrasts the principal issues related to (a) accounting for income taxes and (b) share-based payments as found in official pronouncements of the IASB with those of U.S. GAAP.

Learning Objectives

Completion of this chapter will enable you to:

- Identify the positions taken by the IASB with respect to accounting for income taxes and contrast the positions taken by the IASB with those taken by the FASB.
- Identify the positions taken by the IASB with respect to share-based payments and contrast the positions taken by the IASB with those taken by the FASB.

Accounting for Income Taxes

Accounting for income taxes is addressed under IFRS by IAS 12, *Income Taxes*, and under U.S. GAAP by FASB ASC 740 (formerly SFAS 109, *Accounting for Income Taxes*, and FIN 48, *Accounting for Uncertainty in Income Taxes*).

The accounting models of the two organizations are conceptually quite similar. There are a number of specific differences, however.

Scope

IAS 12 and FASB ASC 740 both are limited to taxes based on income. Taxes that are not based on income are accounted for based on other guidance.

IFRS excludes from its scope government grants in the form of tax benefits and investment tax credits. U.S. GAAP similarly excludes from its scope government grants in the form of tax benefits; however, it includes investment tax credits within its scope.

Total Income Tax Expense

Under both standards, total income tax expense (benefit) is the sum of the current income tax expense (benefit) and deferred income tax expense (benefit), net of any income taxes recognized directly in equity or arising from a business combination.

Temporary Differences

Temporary differences are defined in IAS 12 as “differences between the carrying amount of an asset or liability in the statement of financial position and its tax base.” They are defined similarly in FASB ASC 740 as “differences between the tax basis of an asset or liability and its reported amount in the financial statements that will result in taxable or deductible amounts in future years when the reported amount of the asset or liability is recovered or settled, respectively.” (**FASC ASC 740-10-20**)

Initial Recognition Exemption

Under IFRS, a deferred tax asset or liability is recognized for a temporary difference except to the extent that it arises from the initial recognition of:

- a. Goodwill; or
- b. An asset or liability that:
 - 1) Is not a business combination; and
 - 2) At the time of the transaction, affects neither accounting profit nor taxable profit (tax loss) (**IAS 12, ¶15**)

U.S. GAAP similarly recognizes a deferred tax asset or liability for all taxable temporary differences except those that arise from the initial recognition of goodwill. However, U.S. GAAP does not have an exemption such as that in (b) above.

Under both IFRS and U.S. GAAP, a deferred tax asset or liability is not recognized if it arises from the initial recognition of goodwill (item (a) above). However, under both standards, any temporary difference is subsequently recognized if the goodwill is deductible for tax purposes.

Deferred Tax Asset Recognition

Under IFRS, a deferred tax asset is recognized only to the extent that it is probable that taxable profit will be available against which the deductible temporary differences can be utilized. Conversely, U.S. GAAP recognizes the entire amount of the deferred tax asset and recognizes a valuation allowance to the extent that it is more likely than not that the deferred tax asset will not be realized. Valuation allowances are not allowed to be recognized under IFRS. The term *probable* is not defined in IAS 12.

In determining whether sufficient taxable income (profit) will be available in future periods to realize the tax benefits of deferred tax assets, both IFRS and U.S. GAAP consider tax planning strategies. Nevertheless, unlike IFRS, U.S. GAAP requires that the tax planning strategy be prudent and feasible and an action management ordinarily may not take but has the intent and ability to implement in order to prevent the tax benefit from expiring unused. IFRS does not have any specific guidance as to whether management's intention to use tax planning strategies should affect whether or not those strategies are taken into account in assessing the recognition of a deferred tax asset.

In addition, IFRS is silent as to whether any related expenses that would be incurred as a result of such tax-planning strategies should be taken into account. U.S. GAAP explicitly requires that such expenses be taken into consideration in determining the appropriate valuation allowance.

Measurement

Under IFRS, deferred tax assets and liabilities are measured at the tax rates that are expected to apply to the period when the asset is realized or the liability settled, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. (**IAS 12, ¶47**) U.S. GAAP specifies that the rate to be used is the currently enacted rate(s) for the period in which the asset is expected to be realized or the liability settled. U.S. GAAP does not allow consideration of any "substantively enacted" rate.

Under IFRS, when a non-depreciable item of property, plant and equipment is revalued, the deferred tax on the revaluation is measured using the tax rate that would apply upon disposal. U.S. GAAP does not allow the revaluation of property, plant and equipment.

Both IFRS and U.S. GAAP prohibit the discounting of deferred taxes.

Classification of Deferred Taxes on the Statement of Financial Position

Under IFRS, all deferred tax assets and liabilities are classified as non-current when a classified balance sheet is prepared, even if some part of the tax balance will reverse within twelve months of the reporting date. U.S. GAAP requires that the deferred tax assets and liabilities be classified as either current or non-current according to the classification of the related asset or liability giving rise to the temporary difference. The expected timing of the reversal of deferred tax assets and liabilities is not considered in the classification of deferred tax assets and liabilities except when a deferred tax balance cannot be related to a recognized asset or liability, such as would be the case of deferred tax assets related to operating loss carryforwards.

Accounting for Income Taxes (Part B)

Presentation of Income Tax Expense (Benefit)

Both IFRS and U.S. GAAP require that income tax expense (benefit) be reported in the determination of net income (loss) except to the extent that the income tax arises from a:

- Transaction or event which is recognized outside net income (loss) either in other comprehensive income or directly in equity; or
- Business combination.

For example, the deferred tax associated with an unrealized gain or loss on available for sale securities would be recognized in other comprehensive income rather than in net income. Conversely, both IFRS and U.S. GAAP require that the deferred tax associated with an unrealized gain or loss on trading securities be recognized in net income.

Subsequent Changes in Deferred Tax Assets/Liabilities

After the initial recognition of a deferred tax asset or liability, the balance of a deferred tax asset or liability may change as a result of changes in tax rates or tax laws, tax status of the entity, or assessment of recoverability of a deferred tax asset. Under IFRS, such subsequent changes in deferred tax assets or liabilities related to items credited or charged directly to equity in prior years are recognized directly in equity. However, under U.S. GAAP, such subsequent changes are recognized in net income. If the related deferred tax expense or benefit initially was included in net income, both IFRS and U.S. GAAP would include the subsequent change in the deferred tax asset or liability in net income.

Less-than-50% Owned Investees

Under IFRS, a deferred tax liability is recognized on undistributed earnings of less-than-50% owned investees if (a) the parent cannot control the distribution of the earnings or (b) the reversal of the temporary difference is probable. Conversely, U.S. GAAP requires that a deferred tax liability be recognized on undistributed earnings of less-than-50% owned investees.

Undistributed Earnings of Foreign Entities

Under IFRS, a deferred tax liability is only recognized if the parent cannot control the distribution of earnings or the reversal of the temporary difference is probable. Under U.S. GAAP, taxable temporary differences on undistributed earnings of foreign subsidiaries are recognized unless they will not reverse in the foreseeable future, which requires that (a) the investor is able to control the timing of the reversal and (b) undistributed earnings will be reinvested indefinitely or can be distributed on a tax-free basis.

Intercompany Profits

Under IFRS, deferred taxes on intercompany profits in inventory are recognized based on the buyer's tax rate. Under U.S. GAAP, taxes paid by the seller on intercompany profits are deferred and recognized upon sale to a third party. Further, U.S. GAAP prohibits the recognition of a deferred tax asset for the difference resulting from tax base differences between the respective jurisdictions.

Intercompany Transfer of Assets

Under U.S. GAAP, a deferred tax asset or liability is not recognized for the difference in tax bases between tax jurisdictions as a result of intra-group transfers of assets. IFRS, on the other hand, specifies that such an intercompany transfer of assets between tax jurisdictions is a taxable event that establishes a new tax base for those assets in the buyer's tax jurisdiction. The new tax base of those assets is deductible on the buyer's tax return as those assets are consumed or sold to an unrelated party.

Exchange Rate

U.S. GAAP prohibits the recognition of deferred taxes for differences related to exchange gains and losses on non-monetary assets or liabilities that are remeasured from the local currency into the reporting currency using historical exchange rates. Under IFRS, deferred taxes are recognized on the difference between the carrying amounts determined using the historical exchange rate and the tax base determined using the balance sheet date exchange rate.

Leases

IFRS does not have any special requirements related to providing for deferred taxes on leases. U.S. GAAP, however, provides a specific exemption from the basic principle of accounting for deferred taxes provided in FASB ASC 740 for leveraged leases.

Share-based Payments

Under IFRS, if the estimated deduction from taxable profits related to equity-settled share-based compensation is less than or equal to the cumulative share-based compensation expense, the recognition of the related deferred taxes is recognized in earnings. On the other hand, if the estimated deduction from taxable profits exceeds the cumulative share-based compensation expense, the excess tax benefits received must be recognized directly in equity.

Under U.S. GAAP, a deferred tax asset is recognized for the amount of tax benefit corresponding to compensation expense, subject to certain limitations. If it turns out that the actual tax deduction exceeds cumulative compensation expense, the excess benefit (known as a windfall tax benefit) is credited directly to equity. On the other hand, if the tax deduction is less than the cumulative compensation expense, the deficiency is recognized as a direct charge to equity to the extent of prior windfall tax benefits and as a charge to tax expense for any remainder.

Uncertain Tax Positions

IFRS has no specific guidance on the recognition of uncertain tax positions. U.S. GAAP, on the other hand, has specific guidance on the recognition of uncertain tax provisions. Under U.S. GAAP, the entity should initially recognize the financial effects of a tax position “when it is more likely than not, based on the technical merits, that the position will be sustained upon examination.” (**FASB ASC 740-10-25**) “More likely than not” means a likelihood of more than 50 percent. U.S. GAAP requires that the reporting entity assume that the tax position will be examined by the relevant taxing authority that has full knowledge of all relevant information. U.S. GAAP requires that a tax position that meets the “more-likely-than-not” recognition threshold should be measured initially and subsequently as the largest amount that is greater than 50 percent likely of being realized. This measurement must consider the amounts and probabilities of the outcomes that could be realized upon ultimate settlement.

Under IFRS, there is no specific guidance on the classification of interest and penalties related to income tax uncertain positions. Under U.S. GAAP, the classification of interest and penalties is an accounting policy decision.

Business Combinations

Temporary differences may arise in a business combination. An entity recognizes any resulting deferred tax assets or liabilities at the acquisition date. As a result, those deferred tax assets and deferred tax liabilities affect the amount of goodwill or the bargain purchase gain the entity would otherwise recognize. However, under both IFRS and U.S. GAAP, the entity does not recognize deferred tax liabilities from the initial recognition of goodwill.

After the acquisition, management’s judgment as to the realizability of deferred tax assets may change. In that case, under IFRS, the acquirer recognizes a change in the deferred tax asset in the period of the business combination, but does not include it as part of the accounting for the combination. Any change after this period would be reflected in earnings.

Under U.S. GAAP, if an acquisition is accounted for as a business combination, the subsequent resolution of any acquired tax positions is applied first as an increase or decrease in the goodwill attributable to that acquisition regardless of the timing of resolution. If goodwill, is reduced to zero, the remaining adjustment is used to reduce the value of other non-current intangible assets related to the acquisition, with any remaining residual being recognized as income.

Share-based Transactions

The following discussion includes a number of the similarities and significant differences between U.S. GAAP and IFRS. The discussion is not inclusive of all GAAP differences in this area.

Scope

The fundamental requirements of FASB ASC 718 (formerly SFAS 123R, *Share-Based Payments*), and IFRS 2, *Share-based Payments*, are similar. The standards set forth in both sets of standards apply to transactions with employees and non-employees. Both sets apply to all companies. One difference in the scope of the standards is that employee share option plans (ESOPs) are within the scope of IFRS 2, but under U.S. GAAP have different accounting and reporting requirements.

Transactions with Non-employees

FASB ASC 718 and IFRS 2 require a fair value based approach in accounting for share-based payments to non-employees. An entity receiving goods or services in share-based payment transactions or incurring liabilities based, at least in part, on the price of its shares or that may require settlement in its shares, must measure the transactions at fair value. The two standards define fair value as the amount that willing parties would be willing to buy or sell the asset or settle the liability.

FASB ASC 718 allows the use of either the fair value of the goods or services received or the equity instrument, whichever is more reliably determinable, to value the transaction. Under IFRS 2, an entity bases the value of the transaction on the fair value of the goods or services received, **unless** the fair value of the goods and services **is not** reliably determinable, then the entity may use the fair value of the equity instruments. Thus, allowing the two parties involved in the transaction to value the transaction differently.

FASB ASC 505 (formerly EITF 96-18, *Accounting for Equity Instruments That Are Issued to Other Than Employees for Acquiring, or in Conjunction with Selling, Goods or Services*), provides further guidance. Under FASB ASC 505, the entity measures the value of the equity securities at the earlier of (a) the date the entity and counterparty reach a performance commitment by the counterparty, or (b) the date at which the counterparty's performance is complete.

IFRS 2 **does not** include the performance commitment concept of FASB ASC 718. Under IFRS, the measurement date is the date at which the entity obtains the goods or the counterparty renders the services. This means an entity may recognize the "cost" of non-employee services over time, not solely upon completion of the services.

Transactions with Employees

U.S. GAAP and IFRS measure the fair value of share-based grants on the grant date. The grant date is the date on which the entity and the employee(s) have an understanding of the terms and conditions of the share-based arrangement.

Fair Value Measurement

Both sets of standards require an entity to measure fair value based, if possible, on an observable market price. The FASB and the IASB agreed that if an observable market price is not available, an entity could use an option-pricing model to estimate the fair value of the share-option.

Both FASC ASC 718 and IFRS 2 require the option-pricing models to take into account the same six inputs:

- Exercise price of the option
- Current market price of the share
- Expected volatility of the share price
- Dividends expected to be paid on the shares
- Rate of interest available in the market
- Term of the option

FASC ASC 718 mentions three methods that an entity may use to estimate the fair value of a share-option, the binominal model, the Black-Scholes-Merton (BSM) model, and a Monte Carlo simulation. IFRS 2 specifically mentions the binominal model and the BSM model, but not the use of a Monte Carlo simulation. IFRS 2 prefers the use of the binominal model because the BSM model does not allow for the possibility of the option being exercised prior to the end of its life.

Intrinsic Value Method

If an entity cannot reliably estimate the fair value of an equity instrument, both FASC ASC 718, and IFRS 2 allow the use of the intrinsic value method. However, unlike FASC ASC 718, IFRS 2 does not allow the use of the intrinsic value method for nonpublic entities.

Share-based Grants

U.S. GAAP and IFRS require an entity to recognize share-based grants as either equity-classified grants or liability-classified grants. For equity-classified share-based grants, once measured, an entity **does not** remeasure the fair value of the grant for subsequent changes in the measurement variables. On the other hand, an entity **must** remeasure liability-classified grants until the settlement date.

Equity versus Liability Grants

Under FASC ASC 718, an entity classifies an award as a liability when the award is based on a fixed monetary amount settled in a variable number of shares. However, under IFRS 2 share-settled awards are classified as equity awards even if there is variability in the number of shares due to a fixed monetary value to be achieved.

FASC ASC 718 requires that a single award offering employees a choice of settling the award in stock or cash should be classified as a liability. Whereas, under IFRS 2, awards that offer employees the choice of settlement in stock or cash be treated as a compound instruments.

Graded Vesting

A share-based award has graded vesting when it has multiple vesting dates (e.g., vesting ratably over time, such as 20% per year over a five-year period). Different parts of the award will have different expected terms. IFRS 2 requires measurement of graded vesting awards as, essentially, multiple awards; this requires an entity to determine a separate grant-date fair value for each separately vesting portion of the award.

This requirement will cause entities that issue graded vesting awards to have accelerated expense recognition and a different total value to be expensed (for a given award) in comparison to U.S. GAAP. Under IFRS 2, an entity must separately measure each portion of the plan. This impact could cause some entities to reconfigure their share-based payment plans. By changing the vesting pattern to cliff vesting (where all awards vest at the same time), entities can avoid a front loading of share-based compensation expense.

U.S. GAAP requires entities to make an accounting policy election to recognize compensation cost for graded vesting awards containing only service conditions either on a straight-line basis or on an accelerated basis. If an entity elects to use straight-line amortization, the entity must amortize the cost over the longest vesting period. U.S. GAAP requires this decision regardless of whether the fair value of the award is measured based on the award as a whole or for each individual portion.

Expense Recognition

For equity-classified grants, both sets of standards require recognition of a cost and a corresponding increase in equity. Remember, entities **do not remeasure** equity-classified grants for changes in the value of the equity instruments.

For liability-classified grants, both U.S. GAAP and IFRS require recognition of a cost and a corresponding liability. Remember, liability-classified entities **do remeasure** equity-classified grants for changes in the value of the equity instruments.

Cancellation or Modification of Terms

Under U.S. GAAP and IFRS, a cancellation of a share-based payment plan results in an acceleration of the unrecognized costs.

FASB ASC 718 and IFRS 2 require an entity to recognize any increase in the incremental fair value, but not a reduction in fair value, resulting from a modification of terms of the plan. FASB ASC 718, unlike IFRS 2, for an equity-classified plan, requires that if vesting is improbable under the original terms of the plan, there is no minimum compensation cost that must be recognized.

Disclosures

Finally, FASB ASC 718 and IFRS 2 require comparable disclosures in the financial statements providing users sufficient information to understand the types and extent to which the entity is entering into share-based payment transactions.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

25. Total income tax expense (benefit) is:
- a. The same amount as the current income tax expense (benefit).
 - b. The same as the deferred income tax expense (benefit).
 - c. The sum of the current income tax expense (benefit) and deferred tax expense (benefit).
 - d. The sum of the current income tax expense (benefit) and deferred tax expense (benefit), net of any income taxes recognized directly in equity or arising from a business combination.
26. The amount of deferred tax asset recognized at the date of the statement of financial position at the end of an entity's first year of operations:
- a. Is likely to be different under IFRS than under U.S. GAAP.
 - b. Is likely to be the same under IFRS as under U.S. GAAP.
 - c. Is likely to be zero.
27. With regard to the classification of deferred income taxes on the statement of financial position:
- a. IFRS requires all deferred tax assets and liabilities be classified as current.
 - b. IFRS requires all deferred tax assets and liabilities be classified as non-current.
 - c. U.S. GAAP requires all deferred tax assets and liabilities be classified as current.
 - d. U.S. GAAP requires all deferred tax assets and liabilities be classified as non-current.
28. The deferred tax benefit associated with the initial recognition of an unrealized loss on available-for-sale securities would be:
- a. Included in net income under both IFRS and U.S. GAAP.
 - b. Included in other comprehensive income under both IFRS and U.S. GAAP.
 - c. Included as a direct credit to retained earnings under IFRS and in net income under U.S. GAAP.
 - d. Included in other comprehensive income under IFRS and as a direct credit to retained earnings under U.S. GAAP.

29. After the initial recognition of a deferred tax asset or liability, a change in its balance that results from a change in tax rates or tax laws should be recognized in equity:
- a. Under IFRS and in income under U.S. GAAP if the related deferred tax expense or benefit initially was recognized in net income.
 - b. In all cases under both IFRS and U.S. GAAP.
 - c. Under IFRS in equity and in income under U.S. GAAP, if the related deferred tax expense or benefit initially was recognized in equity.
 - d. U.S. GAAP and in income under IFRS, if the related deferred tax expense or benefit initially was recognized in equity.
30. Under IFRS 2, *Shared-Based Payments*, an entity bases the value of a non-employee transaction on the fair value of the:
- a. Goods or services received or the equity instruments, whichever is more reliably determinable.
 - b. Goods or services received, unless the fair value of the goods or services is not reliably determinable.
31. Which of the following is a difference between FASB ASC 718 and IFRS 2?
- a. Use of the intrinsic value method for nonpublic entities.
 - b. Cancellation of a share based payment plan.
 - c. Expense recognition for equity classified grants.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

25. Total income tax expense (benefit) is: **(Page 75)**

- a. The same amount as the current income tax expense (benefit). [This answer is incorrect. Total income tax expense (benefit) is not limited to the current income tax expense (benefit). It includes other items as well.]
- b. The same as the deferred income tax expense (benefit). [This answer is incorrect. Total income tax expense (benefit) is not limited to the deferred income tax expense (benefit). Total income tax expense (benefit) includes other items as well.]
- c. The sum of the current income tax expense (benefit) and deferred tax expense (benefit). [This answer is incorrect. Total income tax expense (benefit) could be the sum of the current income tax expense (benefit) and deferred tax expense (benefit) but not in all situations.]
- d. **The sum of the current income tax expense (benefit) and deferred tax expense (benefit), net of any income taxes recognized directly in equity or arising from a business combination. [This answer is correct. Under both IFRS and U.S. GAAP, total income tax expense (benefit) includes both the current income tax expense (benefit) and deferred tax expense (benefit) included in net income, net of any income taxes recognized directly in equity arising from a business combination.]**

26. The amount of deferred tax asset recognized at the date of the statement of financial position at the end of an entity's first year of operations: **(Page 76)**

- a. **Is likely to be different under IFRS than under U.S. GAAP. [This answer is correct. The amount under IFRS is likely not to be the same as under U.S. GAAP, because of the different manner in which the total deferred tax asset is recognized.]**
- b. Is likely to be the same under IFRS as under U.S. GAAP. [This answer is incorrect. The amount would be the same only if the probably amount is the same as the gross amount.]
- c. Is likely to be zero. [This answer is incorrect. The amount would be zero only if none of the deferred tax asset is expected to be realized.]

27. With regard to the classification of deferred income taxes on the statement of financial position: **(Page 77)**

- a. IFRS requires all deferred tax assets and liabilities be classified as current. [This answer is incorrect. IFRS does not require all deferred tax assets and liabilities be classified as current. At least some of the deferred tax assets and liabilities must be classified as non-current under IFRS.]
- b. **IFRS requires all deferred tax assets and liabilities be classified as non-current. [This answer is correct. IFRS requires that all deferred tax assets and liabilities be classified as non-current. This requirement is different from that of U.S. GAAP.]**

- c. U.S. GAAP requires all deferred tax assets and liabilities be classified as current. [This answer is incorrect. U.S. GAAP does not require all deferred tax assets and liabilities be classified as current. U.S. GAAP recognizes that in some cases deferred tax assets or liabilities should be classified as non-current.]
 - d. U.S. GAAP requires all deferred tax assets and liabilities be classified as non-current. [This answer is correct. U.S. GAAP does not require all deferred tax assets and liabilities be classified as non-current. U.S. GAAP recognizes that in some cases deferred tax assets or liabilities should be classified as current.]
28. The deferred tax benefit associated with the initial recognition of an unrealized loss on available-for-sale securities would be: **(Page 77)**
- a. Included in net income under both IFRS and U.S. GAAP. [This answer is incorrect. At least one of the two, IFRS or U.S. GAAP, would not include the deferred tax benefit in net income.]
 - b. Included in other comprehensive income under both IFRS and U.S. GAAP. [This answer is correct. Since the unrealized loss is included in other comprehensive income, both IFRS and U.S. GAAP require that the related deferred tax benefit also be included in other comprehensive income.]**
 - c. Included as a direct credit to retained earnings under IFRS and in net income under U.S. GAAP. [This answer is incorrect. Without prejudice to what U.S. GAAP requires, IFRS does not allow the deferred tax benefit to be recognized as a direct credit to retained earnings.]
 - d. Included in other comprehensive income under IFRS and as a direct credit to retained earnings under U.S. GAAP. [This answer is incorrect. Without prejudice to what IFRS requires, U.S. GAAP does not allow the deferred tax benefit to be recognized as a direct credit to retained earnings.]
29. After the initial recognition of a deferred tax asset or liability, a change in its balance that results from a change in tax rates or tax laws should be recognized in equity: **(Page 77)**
- a. Under IFRS and in income under U.S. GAAP if the related deferred tax expense or benefit initially was recognized in net income. [This answer is incorrect. IFRS would require that the change in the deferred tax asset or liability be included in net income rather than equity if the related deferred tax expense or benefit initially was recognized in net income.]
 - b. In all cases under both IFRS and U.S. GAAP. [This answer is incorrect. At least one of the two, IFRS or U.S. GAAP, would require such changes be reflected in net income.]
 - c. Under IFRS in equity and in income under U.S. GAAP, if the related deferred tax expense or benefit initially was recognized in equity. [This answer is correct. If the related deferred tax expense or benefit initially was recognized in equity, IFRS requires that the change in the deferred tax assets or liability also be recognized in equity. U.S. GAAP, on the other hand, requires that such changes be reflected in net income.]**

- d. U.S. GAAP and in income under IFRS, if the related deferred tax expense or benefit initially was recognized in equity. [This answer is incorrect. At least one of the two, IFRS or U.S. GAAP, requires that such a change be accounted for differently than the method herein listed. For example, U.S. GAAP would not include such changes in equity.]
30. Under IFRS 2, *Shared-Based Payments*, an entity bases the value of a non-employee transaction on the fair value of the: **(Page 80)**
- a. Goods or services received or the equity instruments, whichever is more reliably determinable. [This answer is incorrect. FASB ASC 718, requires non-employee transactions to be valued at the fair value of goods or services received or the equity instruments, whichever is more reliably determinable, IFRS 2 does not have this requirement.]
 - b. **Goods or services received, unless the fair value of the goods or services is not reliably determinable. [This answer is correct. Under IFRS 2 an entity bases the value of a non-employee transaction on the fair value of the goods or services received, unless the fair value of the goods and services is not reliably determinable, then the entity may use the fair value of the equity instruments.]**
31. Which of the following is a difference between FASB ASC 178 and IFRS 2? **(Page 81)**
- a. **Use of the intrinsic value method for nonpublic entities. [This answer is correct. Although both FASB ASC 718 and IFRS 2 allow the use of the intrinsic value method when the entity cannot reliably estimate the fair value of an equity instrument, IFRS does not allow the used of the intrinsic value method for the nonpublic entities.]**
 - b. Cancellation of a share based payment plan. [This answer is incorrect. Under both U.S. GAAP and IFRS, a cancellation of a share-based payment plan results in an acceleration of the unrecognized costs.]
 - c. Expense recognition for equity classified grants. [This answer is incorrect. For liability-classified grants, both U.S. GAAP and IFRS require recognition of a cost and a corresponding increase in equity.]

EXAMINATION FOR CPE CREDIT

Chapter 5

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

23. How does the scope of IAS 12 compare to the scope of SFAS 109?
- a. The scope of IAS 12 is limited to taxes based on income, but SFAS 109 addresses all taxes.
 - b. IAS 12 addresses all taxes, but SFAS 109 is limited to taxes based on income.
 - c. The scope of both IAS 12 and SFAS 109 are limited to taxes based on income.
 - d. Both IAS 12 and SFAS 109 address all taxes.
24. The deferred tax expense associated with the initial recognition of an unrealized gain on trading securities would be:
- a. Included in net income under both IFRS and U.S. GAAP.
 - b. Included in other comprehensive income under both IFRS and U.S. GAAP.
 - c. Included in net income under IFRS and other comprehensive income under U.S. GAAP.
 - d. Included in other comprehensive income under IFRS and net income under U.S. GAAP.
25. Under the fair value method, total compensation cost is measured:
- a. At the date of the grant.
 - b. At the time the options are exercised.
 - c. Over the expected life of the options.
 - d. Over the contractual period of the options.
26. Which of the following is **not** one of the six measurement variables that an option-pricing model must include in estimating the fair value of a share option under both SFAS 123F and IFRS 2?
- a. Dividends expected to be paid on the shares.
 - b. Expected volatility of the share price.
 - c. Term of the option.
 - d. Current price of the option.

27. Which type of vesting allows an entity to avoid front loading of share-based compensation expense?
- a. Graded vesting.
 - b. Cliff vesting.
 - c. Do not select this answer choice.
 - d. Do not select this answer choice.

Chapter 6: Business Combinations and Consolidated Financial Statements

Introduction

This chapter summarizes the principal issues related to business combinations and consolidated financial statements as found in official pronouncements of the IASB and a comparison of the IASB's position on those issues with U.S. GAAP.

Learning Objectives

Completion of this chapter will enable you to:

- Identify the positions taken by the IASB with respect to business combinations and contrast them with those of the FASB.
- Identify the positions taken by the IASB regarding consolidated financial statements and contrast them with those of the FASB.

Business Combinations—Part A

Initially, the IASB and the FASB separately addressed the issue of business combinations. This phase of the respective business combination projects led to the issuance by the FASB of FASB ASC 805 (formerly SFAS 141, *Business Combinations*), and the IASB of IFRS 3, *Business Combinations*. Subsequently, in 2002, the IASB and the FASB agreed jointly to reconsider those two pronouncements. IFRS 3R, *Business Combinations*, and FASB ASC 805 are the result of that joint effort. The IASB and the FASB reached similar conclusions on most of the key issues but differed on certain specific issues.

Scope Exception for Not-for-profit Organizations

FASB ASC 805 does not apply to combinations of not-for-profit organizations or the acquisition of a for-profit business by a not-for-profit organization. In contrast, IFRS generally does not have scope limitations for not-for-profit activities in the private or public sector. As a result, this scope exception is not necessary for IFRS 3R.

Fundamental Accounting Model

Both Boards adopted the acquisition method, which is somewhat similar to the purchase method. A major difference, however, is that under the acquisition method all assets acquired, liabilities assumed, and any noncontrolling interest (NCI) in the acquiree at the acquisition date are measured at their fair values at that date, with limited exceptions. Under the purchase method, fair value would have been used only for the acquirer's share of the acquiree's assets and the liabilities assumed.

Application of the acquisition method requires the following:

- Identification of the acquirer,
- Determination of the acquisition date,
- Recognition and measurement of the identifiable assets acquired, the liabilities assumed, and any noncontrolling interest (NCI) in the acquiree, and
- Recognition and measurement of goodwill or a gain from a bargain purchase.

Identification of Acquirer

General Case

The IASB uses the guidance on control in IAS 27R, *Consolidated and Separate Financial Statements*, to identify the acquirer. Control is defined as “the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.” (IAS 27R, ¶4) The FASB, on the other hand, uses the guidance on controlling financial interest in FASB ASC 810 (formerly ARB 51, *Consolidated Financial Statements*, as amended) and FASB ASC 805.

Variable Interest Entities

The FASB specifies that the primary beneficiary of a variable interest entity is always the acquirer. The determination of which party is the primary beneficiary is made in accordance with FASB ASC 810. In contrast, IFRS 3R does not have guidance for primary beneficiaries because it does not have consolidation guidance similar to that found in FASB ASC 810 for variable interest entities.

Business Combinations—Part B

Determination of Acquisition Date

The IASB and FASB both identify the acquisition date as the date on which control is transferred to the acquirer. It typically is the closing date, which is the date on which the acquirer legally transfers consideration, acquires the assets, and assumes the liabilities of the acquiree.

Recognition and Measurement of Assets Acquired, Liabilities Assumed and NCI

General Measurement Principle

IFRS 3R and FASB ASC 810 both follow a general recognition principle that as of the acquisition date the acquirer should recognize, separately from goodwill, the identifiable assets acquired, the liabilities assumed, and any NCI. There are exceptions in each pronouncement to the general principle of measurement at fair value. These exceptions are discussed in subsequent sections.

Definition of Fair Value

Fair value is defined in IFRS 3R as “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.”

FASB ASC 820-10-20, 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.” It should be noted, however, that the IASB currently has a separate project in which it is reconsidering the definition of fair value.

Measurement of NCI in an Acquiree

Initial Recognition. IFRS 3R allows an acquirer to measure the NCI in an acquiree either at fair value or as its proportional share of the acquiree’s identifiable net assets. Conversely, FASB ASC 805 only allows it to be measured at fair value. **(FASB ASC 805-20-30)**

Disclosures. Since IFRS 3R allows an acquirer to measure the NCI at either its fair value or its proportional share of the acquiree’s identifiable net assets, it also requires the acquirer to disclose the measurement basis used. In addition, if the NCI is measured at fair value, the acquirer must disclose the valuation techniques and key model inputs used. Similarly, FASB ASC 805 requires an acquirer to disclose the valuation technique(s) used and significant inputs used to measure fair value. **(FASB ASC 805-20-50)**

Exceptions to General Recognition and Measurement Principles—Contingencies

Initial Recognition. IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, defines a contingent liability as a:

- Possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- Present obligation that arises from past events but is not recognized because:
 - It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - The amount of the obligation cannot be measured with sufficient reliability.

(IAS 37, ¶10)

However, the requirements in IAS 37 do not apply to the recognition of a contingent liability assumed in a business combination. In the latter case, the acquirer must recognize as of the acquisition date a contingent liability if it is a present obligation that arises from past events and its fair value can be measured reliably. **(IFRS 3R, ¶23)** Thus, the acquirer recognizes a contingent liability assumed in a business combination at the acquisition date even if it is not probable that an outflow of economic resources will be required to settle the obligation.

In contrast, FASB ASC 805 requires the acquirer to recognize as of the acquisition date the assets acquired and liabilities assumed that arise from contractual contingencies, measured at their acquisition-date fair values. The acquirer must recognize noncontractual contingencies as an asset or liability as of the acquisition date if it is more likely than not that the contingency gives rise to an asset or a liability as defined in SFAC 6, *Elements of Financial Statements*. Noncontractual contingencies that fail the more likely than not threshold as of the acquisition date are accounted for in accordance with other U.S. GAAP, including SFAS 5, *Accounting for Contingencies*.

FASB ASC 805 provides implementation guidance for applying the more-likely-than-not criterion for recognizing noncontractual contingencies. IFRS 3R does not have comparable implementation guidance.

Subsequent Measurement. IFRS 3R specifies that a contingent liability recognized in a business combination should be measured subsequently at the higher of the amount that would be recognized under IAS 37, or the amount initially recognized less any accumulated amortization recognized in accordance with IAS 18, *Revenue*. In contrast, FASB ASC 805 requires an acquirer to continue to report an asset or liability arising from a contractual or noncontractual contingency that is recognized as of the acquisition date that otherwise would be in the scope of FASB ASC 450 if not acquired or assumed in a business combination at its acquisition-date fair value until the acquirer obtains new information about the possible outcome of the contingency.

The acquirer evaluates that new information and measures the asset or liability as follows:

- A liability is measured at the higher of:
 - Its acquisition-date fair value; or
 - The amount that would be recognized if applying FASB ASC 450.
- An asset is measured at the lower of:
 - Its acquisition-date fair value; or
 - The best estimate of its future settlement amount. **(SFAS 141R, ¶62–63)**

Other Exceptions to General Recognition and Measurement Principles

IFRS 3R and FASB ASC 450 both provide exceptions to the general recognition and measurement principles that the acquirer applies in accordance with other specific IFRSs or FASB ASCs. An example is the measurement of income taxes and any related deferred income tax assets or liabilities. Those differences in the respective pronouncements could result in differences in the amounts recognized in a business combination. The differences related to those items (e.g., those related to income taxes generally) are discussed in other chapters of this course. Those unique to business combinations are discussed in this chapter (business combinations) of the course.

Operating Leases

IFRS 3R requires the acquirer to take into account the terms of a lease in measuring the acquisition-date fair value of an asset that is subject to an operating lease in which the acquiree is the lessor. However, IFRS 3R does not require the acquirer of an operating lease in which the acquirer is the lessor to recognize a separate asset or liability *if* the terms of an operating lease are favorable or unfavorable compared with market terms as is required for leases in which the acquiree is the lessee. **(IFRS 3R, ¶B29, B49)**

In contrast, FASB ASC 805 specifies that regardless of whether the acquiree is the lessee or the lessor, the acquirer must recognize an intangible asset if the terms of the operating lease are favorable relative to the market terms or a liability if the terms are unfavorable relative to market terms. Thus, under U.S. GAAP, an acquirer must measure the acquisition-date fair value of an asset subject to an operating lease in which the acquiree is the lessor separately from the lease contract. **(FASB ASC 805-20-25)**

Replacement Share-based Payment Awards

IFRS 3R requires an acquirer to account for share-based payment awards that it exchanges for awards held by employees of the acquiree in accordance with IFRS 2, *Share-based payment*. FASB ASC 805 requires the acquirer to account for those awards in accordance with FASB ASC 718 (formerly SFAS 123R, *Share-Based Payment*). As a result, differences between IFRS 2 and SFAS 123R could lead to differences in the accounting for share-based payment awards entered into as part of a business combination. The general differences in SFAS 2 and SFAS 123R are discussed in another chapter of this course.

Income Taxes

IFRS 3R and FASB ASC 805 require the subsequent recognition of acquired deferred tax benefits in accordance with IAS 12, *Income Taxes*, or FASB ASC 740 (formerly SFAS 109, *Accounting for Income Taxes*), respectively. Differences between IAS 12 and FASB ASC 740 could cause differences in the subsequent recognition. (General differences between IAS 12 and FASB ASC 740 are discussed in another chapter of this course.) In addition, under U.S. GAAP, the acquirer is required to account for changes in the acquired income tax positions in accordance with FASB ASC 740 (formerly FIN 48, *Accounting for Uncertainty in Income Taxes*).

Goodwill and Bargain Purchase Recognition, Measurement and Disclosure

Fundamentally, the recognition and measurement of goodwill and any bargain purchase under IFRS 3R is similar to that in FASB ASC 805. There are some disclosure differences, however.

Goodwill by Reportable Segment

IFRS 3R does not require the disclosure of goodwill by reportable segment. Rather, IAS 36, *Impairment of Assets*, requires an entity to disclose the aggregate carrying amount of goodwill allocated to each cash-generating unit for which the carrying amount of goodwill allocated to that unit is significant in comparison with the entity's total carrying amount of goodwill.

In contrast, FASB ASC 805 requires the acquirer to disclose for each business combination that occurs during the period (or in the aggregate for individually immaterial business combinations) that are material collectively, the amount of goodwill by reportable segment, if the combined entity is required to disclose segment information in accordance with FASB ASC 280 (formerly SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*), unless such disclosure is impracticable. FASB ASC 805 requires disclosure of this information in the aggregate, by each reportable segment.

Disclosure of Goodwill Reconciliation

IFRS 3R requires an acquirer to provide a goodwill reconciliation and provides a detailed list of items that should be shown separately. FASB ASC 805 requires an acquirer to provide a goodwill reconciliation in accordance with the requirements of FASB ASC 350 (formerly SFAS 142, *Goodwill and Other Intangible Assets*). FASB ASC 805 amended FASB ASC 350 to align the level of detail in the reconciliation with that required by IFRS 3R. As a result, there is no substantive difference between IFRS 3R and FASB ASC 805 with regard to these disclosure requirements.

Pro Forma Disclosures

The pro forma disclosures of IFRS 3R apply to all acquirers, whereas they apply only to acquirers that are public business enterprises under FASB ASC 805.

IFRS 3R does not require the disclosure of revenue and profit or loss of the combined entity for the comparable prior period even if comparative financial statements are presented. In contrast, FASB ASC 805 specifies that if comparative financial statements are presented, revenue and earnings for the combined entity for the comparable prior reporting period must be disclosed as if the acquisition date for all business combinations that occurred during the current year had occurred as of the beginning of the comparable prior annual reporting period.

Disclosure of the Financial Effects of Adjustments to the Amounts Recognized in a Business Combination

IFRS 3R requires the acquirer to disclose the amount and an explanation of any gain or loss recognized in the current period that (a) relates to the identifiable assets acquired or liabilities assumed in a business combination that was effected in the current or previous reporting period and (b) is of such a size, nature or incidence that disclosure is relevant to understanding the combined entity's financial statements. FASB ASC 805 has no comparable disclosure requirement.

Consolidated Financial Statements

Applicable Standards

The standards that govern consolidated financial statements under IFRS, are IAS 27R, *Consolidated and Separate Financial Statements*, and SIC-12, *Consolidation—Special Purpose Entities*. The principal guidance under U.S. GAAP is FASB ASC 810 (formerly ARB 51, *Consolidated Financial Statements*; SFAS 94, *Consolidation of All Majority-Owned Subsidiaries*, SFAS 160, *Noncontrolling Interests in Consolidated Financial Statements*, and FIN 46R, *Consolidation of Variable Interest Entities*).

The IASB currently has outstanding an exposure draft, *Consolidated Financial Statements*, that should result in the issuance of a final statement sometime in Q4 of 2010. The final IFRS, of course, could result in changes in the IASB's position and, therefore, in the similarities and differences as compared to U.S. GAAP. This subchapter is based on existing IFRS and existing U.S. GAAP as of May 2010.

General Consolidation Principle

Under both IFRS and U.S. GAAP, the decision as to whether to consolidate an entity is based on *control*; however, the two Boards define and apply the concept of control somewhat differently. The primary focus under IFRS is on the *power to control*, with control defined as the "power to govern the financial and operating policies of an entity to obtain benefits from its activities." (IAS 27, ¶14) U.S. GAAP focuses on controlling financial interests, using a two-tier system to evaluate control. First, FASB ASC 810 is applied to determine if the entity is a variable interest entity (VIE). If so, the decision of whether to consolidate the entity is based on the risks and rewards model described in FASB ASC 810. Specifically, under FASB ASC 810, an entity must consolidate a VIE if that entity has a variable interest that will absorb a majority of the other entity's expected losses, receive a majority of its expected residual returns, or both.

For all non-VIEs, the parent must consolidate the entity (subsidiary) if the parent owns a majority of the voting shares unless control does not rest with the controlling interest (e.g., if the subsidiary is in legal reorganization).

IFRS currently do not have a concept of variable interest entities.

A Closer Look at Control, Including *De Facto* Control

Under IFRS, control also exists when the parent owns half or less of the voting power of an entity when there is power:

- Over more than half of the voting rights by virtue of an agreement with other investors;
- To govern the financial and operating policies of the entity under a statute or an agreement;
- To appoint or remove the majority of the members of the board of directors or equivalent governing body and control of the entity is by that board or body; or
- To cast the majority of votes at meetings of the board of directors or equivalent governing body and control of the entity is by that board or body. **(IAS 27, ¶13)**

Under IFRS, the existence of *potential* voting rights is taken into consideration when evaluating voting control. Conversely, potential voting rights are *not* taken into consideration under the voting control model under U.S. GAAP.

IFRS are unclear as to whether control should be assessed using a power-to-control model (based solely on legal or contractual rights) or a *de facto* control model (based on practical circumstances in addition to legal or contractual rights). *De facto* control is not a basis for consolidation under U.S. GAAP.

Limited Exemptions Related to Parent under IFRS

Under IFRS, a parent must present consolidated financial statements unless the:

- Parent is a wholly-owned subsidiary,
- Parent is a partially-owned subsidiary and all owners have been informed and they do not object to the parent not preparing consolidated financial statements,
- Parent's debt or equity instruments are not traded in a public market,
- Parent did not file, and is not in the process of filing, its financial statements with a regulatory organization for the purpose of issuing any class of instruments in a public market, and
- Ultimate or any intermediate parent of the parent produces consolidated financial statements available for public use that comply with IFRS.

U.S. GAAP does not allow for such exemptions. U.S. GAAP requires an entity to prepare consolidated financial statements if it had at least one subsidiary at any time during the current period or had a variable interest entity that qualified for consolidation under FASB ASC 810.

Subsidiaries Included

All subsidiaries are consolidated under IFRS. U.S. GAAP allows limited exceptions in certain cases for subsidiaries in certain specialized industries. For example, qualified investment companies may be excluded under U.S. GAAP.

Uniformity of Accounting Policies

IFRS requires that the same accounting policies be used throughout the consolidated group. U.S. GAAP does not have such a requirement, as long as the accounting policies are in accordance with U.S. GAAP.

Presentation of NCI Interests on Statement of Financial Position

IFRS and U.S. GAAP both require that NCI be presented in equity separate from the controlling (parent's) interest. The requirement that NCI be presented in equity rather than as a liability or between liabilities and equity is one more example of where U.S. GAAP has converged with IFRS.

Presentation of NCI's Share of Earnings

IFRS and U.S. GAAP both require that the consolidated net income (comprehensive income) be presented, allocated between the controlling and noncontrolling interests. Both specify that the noncontrolling interests share should be presented as an allocation of consolidated net income (comprehensive income) rather than as a deduction to arrive at the controlling interests' share of net income.

The presentation of the NCI's share of consolidated (comprehensive) income is another illustration of the convergence of U.S. GAAP and IFRS.

Losses that Exceed NCI

Under IFRS, losses that exceed the NCI in the equity of a subsidiary may create a debit balance related to NCI *only if* the NCI has an obligation to fund the losses and is able to make an additional investment to cover the losses. Conversely, under U.S. GAAP, losses that exceed NCI may create a debit balance in NCI.

Measurement of NCI

Under IFRS, if the acquirer does not obtain all of the ownership interests in the acquiree, NCI is measured either at:

- Fair value at the acquisition date, or
- Its proportionate interest in the values assigned to the identifiable assets and liabilities of the acquiree in the acquisition accounting.

This election is made on a transaction-by-transaction basis.

Under U.S. GAAP, NCI *must be* measured at fair value at the acquisition date. It does not allow any alternative measurements.

Different Reporting Periods

Under IFRS, the reporting periods of a parent and its subsidiaries cannot differ by more than three months. If the reporting periods differ, adjustments *must* be made for the effects of significant transactions and events between the reporting dates. Like IFRS, U.S. GAAP does not allow reporting periods to differ by more than three months. However, under U.S. GAAP, the effects of significant transactions and events between the reporting dates usually must only be disclosed; however, in certain circumstances such transactions and events also may be recognized in the financial statements.

Special Purpose Entity (SPE)

Under IFRS, a special purpose entity (SPE) may be created to accomplish a narrow and well-defined objective and may take the form of a corporation, trust, partnership or unincorporated entity. SIC-12 specifies that an SPE should be consolidated when the substance of the relationship between an entity and the SPE indicates that the SPE is controlled by that entity. All entities, including SPEs, are assessed for consolidation under the control model. Under U.S. GAAP, consolidation requirements focus on whether an entity is a variable interest entity regardless of whether it would be considered an SPE.

SIC-12, *Consolidation-Special Purpose Entities*, applies to activities regardless of whether they are conducted by a legal entity. Under U.S. GAAP, FASB ASC 810 applies to legal entities.

Qualifying Special Purpose Entity (QSPE)

Under U.S. GAAP, if the structure of the SPE meets the definition of a Qualified Special Purpose Entity (QSPE), it is excluded from the scope of FASB ASC 810 and assessed under the voting control model. IFRS does not contain a similar concept of a QSPE.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

32. Which of the following statements is correct with respect to the positions of the IASB and the FASB regarding business combinations in IFRS 3R and FASB ASC 805, respectively?
- a. The two Boards agreed on all substantive issues.
 - b. The two Boards could not agree on any of the substantive issues, but agreed on certain lesser issues.
 - c. The two Boards agreed on most of the substantive issues and most of the lesser issues.
 - d. The two Boards never compared their positions on business combinations.
33. The IASB's latest position on business combinations is reflected in IFRS 3R, with the FASB's position described in FASB ASC 805. These respective pronouncements indicate that with respect to the fundamental method that should be used to account for a business combination:
- a. The IASB subscribes to the pooling of interest method, while the FASB subscribes to the purchase method.
 - b. The IASB subscribes to the purchase method, while the FASB subscribes to the acquisition method.
 - c. The IASB and the FASB both subscribe to the acquisition method.
34. Which of the following is **not** required when the acquisition method is applied?
- a. Identification of the acquirer.
 - b. Determination of the acquisition date.
 - c. Recognition and measurement of goodwill or any gain from a bargain purchase.
 - d. Determination of the amortization period for goodwill recognized in the business combination.

35. Which of the following statements is **incorrect** with respect to which entities must be included in a parent's consolidated financial statements?
- a. IFRS allows subsidiaries whose business is substantially different from that of the parent to be excluded from the consolidated financial statements.
 - b. U.S. GAAP allows qualified investment companies to be excluded from the consolidated financial statements.
 - c. IFRS requires all subsidiaries to be included in the consolidated financial statements.
 - d. The concept of control is defined differently in U.S. GAAP than under IFRS. Accordingly, the number of entities that must be included in the consolidated financial statements could be different under U.S. GAAP as compared to IFRS.
36. Which of the following statements are correct with respect to how IFRS 3R and FASB ASC 718 require an acquirer to measure the noncontrolling interest (NCI) in its consolidated financial statements?
- a. IFRS 3R allows an entity to measure NCI only at its fair value, while FASB ASC 718 allows NCI to be measured only at its proportional share of the acquiree's identifiable net assets.
 - b. IFRS 3R allows an entity to measure NCI at either its fair value or its proportional share of the acquiree's identifiable net assets, while FASB ASC 718 allows NCI to be measured only at its fair value.
 - c. IFRS 3R allows an entity to measure NCI only at its proportional share of the acquiree's identifiable net assets, while FASB ASC 718 allows NCI to be measured at either its fair value or its proportional share of the acquiree's identifiable net assets.
 - d. IFRS 3R and FASB ASC 718 both allow an entity to measure NCI only at its fair value.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

32. Which of the following statements is correct with respect to the positions of the IASB and the FASB regarding business combinations in IFRS 3R and FASB ASC 805, respectively? **(Page 91)**
- a. The two Boards agreed on all substantive issues. [This answer is incorrect. There are certain issues on which the two Boards have not yet reached agreement. For example, the IASB allows entities to early adopt IFRS 3R, whereas the FASB prohibits early adoption of FASB ASC 805.]
 - b. The two Boards could not agree on any of the substantive issues, but agreed on certain lesser issues. [This answer is incorrect. The two Boards agreed on at least some of the substantive issues. For example, they both agreed that the acquisition method should be used.]
 - c. **The two Boards agreed on most of the substantive issues and most of the lesser issues. [This answer is correct. The two Boards agreed on most of the key points but differed on certain specific issues. The convergence of the two Boards is significant as reflected in IFRS 3R and FASB ASC 805, but the convergence is not totally complete with respect to business combinations.]**
 - d. The two Boards never compared their positions on business combinations. [This answer is incorrect. The two Boards did compare their positions. An appendix of IFRS 3R shows the IASB's comparison of the two Boards' positions.]
33. The IASB's latest position on business combinations is reflected in IFRS 3R, with the FASB's position described in FASB ASC 805. These respective pronouncements indicate that with respect to the fundamental method that should be used to account for a business combination: **(Page 91)**
- a. The IASB subscribes to the pooling of interest method, while the FASB subscribes to the purchase method. [This answer is incorrect. The IASB does not subscribe to the pooling of interests method. The IASB rejected the pooling of interests method even before it issued IFRS 3R.]
 - b. The IASB subscribes to the purchase method, while the FASB subscribes to the acquisition method. [This answer is incorrect. The IASB does not subscribe to the purchase method. The purchase method focused on the acquirer and not the complete economic entity.]
 - c. **The IASB and the FASB both subscribe to the acquisition method. [This answer is correct. The IASB and the FASB both subscribe to the acquisition method. While it is somewhat similar to the purchase method, the acquisition method focuses on all of the assets and liabilities of the acquiree, whereas the purchase method focuses primarily on the acquiree's assets and liabilities acquired by the acquirer.]**

34. Which of the following is **not** required when the acquisition method is applied? (Page 92)

- a. Identification of the acquirer. [This answer is incorrect. The application of the acquisition method requires the identification of the acquirer. IFRS 3R and FASB ASC 805 both provide guidance for the identification of the acquirer.]
- b. Determination of the acquisition date. [This answer is incorrect. The determination of the acquisition date is a specific requirement for the application of the acquisition method. IFRS 3R and FASB ASC 805 both provide specific guidance for the determination of the acquisition date.]
- c. Recognition and measurement of goodwill or any gain from a bargain purchase. [This answer is incorrect. The recognition and measurement of goodwill is a salient aspect of the application of the acquisition method. IFRS 3R and FASB ASC 805 agree on the major aspects of this recognition and measurement.]
- d. **Determination of the amortization period for goodwill recognized in the business combination.** [This answer is correct. Neither IFRS 3R nor FASB ASC 805 allows goodwill to be amortized. However, both require goodwill to be tested for impairment at least annually.]

35. Which of the following statements is **incorrect** with respect to which entities must be included in a parent's consolidated financial statements? (Page 98)

- a. **IFRS allows subsidiaries whose business is substantially different from that of the parent to be excluded from the consolidated financial statements.** [This answer is correct. IAS 27 requires such entities to be included in the consolidated financial statements.]
- b. U.S. GAAP allows qualified investment companies to be excluded from the consolidated financial statements. [This answer is incorrect. U.S. GAAP allows certain subsidiaries to be excluded. An investment company is an example of one that may be included in the consolidated financial statements.]
- c. IFRS requires all subsidiaries to be included in the consolidated financial statements. [This answer is incorrect. IFRS presents less leeway than U.S. GAAP as to whether all subsidiaries would have to be included in the consolidated financial statements.]
- d. The concept of control is defined differently in U.S. GAAP than under IFRS. Accordingly, the number of entities that must be included in the consolidated financial statements could be different under U.S. GAAP as compared to IFRS. [This answer is incorrect. The definition of control is somewhat different under U.S. GAAP than under IFRS. As a result, certain entities would be included in the consolidated financial statements under U.S. GAAP that might not be under IFRS.]

36. Which of the following statements is correct with respect to how IFRS 3R and FASB ASC 805 require an acquirer to measure the noncontrolling interest (NCI) in its consolidated financial statements? **(Page 98)**

- a. IFRS 3R allows an entity to measure NCI only at its fair value, while FASB ASC 805 allows NCI to be measured only at its proportional share of the acquiree's identifiable net assets. [This answer is incorrect. At a minimum, FASB ASC 805 does not allow NCI to be measured at its proportional share of the acquiree's identifiable net asset.]
- b. IFRS 3R allows an entity to measure NCI at either its fair value or its proportional share of the acquiree's identifiable net assets, while FASB ASC 805 allows NCI to be measured only at its fair value. [This answer is correct. This is one of the remaining differences in the attempt of the two boards to converge the accounting and reporting for business combinations. The FASB (FASB ASC 805) does not allow a choice, which the IASB (IFRS 3R) does.]**
- c. IFRS 3R allows an entity to measure NCI only at its proportional share of the acquiree's identifiable net assets, while FASB ASC 805 allows NCI to be measured at either its fair value or its proportional share of the acquiree's identifiable net assets. [This answer is incorrect. At a minimum, the FASB in FASB ASC 805 does not allow a choice as to how NCI must be measured.]
- d. IFRS 3R and FASB ASC 805 both allow an entity to measure NCI only at its fair value. [This answer is incorrect. NCI can be measured by more than its fair value by one of the standards.]

EXAMINATION FOR CPE CREDIT

Chapter 6

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

28. Which of the following statements is correct with respect to scope exceptions allowed under IFRS 3R and FASB ASC 805?
- a. Neither IFRS 3R nor FASB ASC 805 applies to combinations of not-for-profit organizations.
 - b. FASB ASC 805 applies to combinations for not-for-profit organizations but IFRS 3R does not.
 - c. Neither IFRS 3R nor FASB ASC 805 applies to the acquisition of a for-profit business by a not-for profit organization.
 - d. IFRS 3R applies to the acquisition of a for-profit organization by a not-for-profit organization but FASB ASC 805 does not.
29. The FASB specifies that the primary beneficiary of a variable interest entity is always the acquirer. Under U.S. GAAP, the determination of which party is the primary beneficiary is made in accordance with:
- a. FASB ASC 810 (formerly FIN 46R, *Consolidation of Variable Interest Entities* and *ARB 51, Consolidated Financial Statements*).
 - b. FASB ASC 805 (formerly SFAS 141R, *Business Combinations*).
 - c. IFRS 3R, *Business Combinations*.
 - d. Do not select this answer choice.
30. The acquisition date of a business combination is:
- a. The date on which all substantive items are agreed upon under IFRS 3R and the closing date under FASB ASC 805.
 - b. The date on which all substantive items are agreed upon under FASB ASC 805 and the closing date under IFRS 3R.
 - c. The date on which management of the acquirer began serious negotiations under both IFRS 3R and FASB ASC 805.
 - d. The closing date under both IFRS 3R and FASB ASC 805.

31. Which of the following statements is correct with respect to whether the respective entities included in consolidated financial statements must use the same accounting policies?
- a. Both IFRS and U.S. GAAP require the same policies be used throughout the consolidated group.
 - b. Neither IFRS nor U.S. GAAP requires the same policies be used throughout the consolidated group.
 - c. U.S. GAAP does not require that the same accounting policies be used throughout the consolidated group, as long as they are in accordance with U.S. GAAP, but IFRS does require it.
 - d. U.S. GAAP requires that the same accounting policies be used throughout the consolidated group, but IFRS does not as long as the accounting policies are in accordance with IFRS.
32. Which of the following statements is correct with respect to the presentation of the noncontrolling interest (NCI) on the statement of financial position?
- a. IFRS requires NCI to be presented as a component of equity separate from the controlling interest, whereas U.S. GAAP allows NCI to be presented either as a component of equity or between liabilities and equity.
 - b. Both IFRS and U.S. GAAP require that NCI be presented as a component of equity separate from the controlling interest.
 - c. U.S. GAAP requires NCI to be presented as a component of equity separate from the controlling interest, whereas IFRS allows NCI to be presented either as a component of equity or between liabilities and equity.
 - d. Both IFRS and U.S. GAAP allows NCI to be presented either as a component of equity or between liabilities and equity.

Chapter 7: Provisions, Contingencies, Revenue Recognition and Miscellaneous Topics

Introduction

This chapter includes a broad range of topics including, but not limited to, liability provisions, contingencies, revenue recognition, segment reporting, and inventory valuation.

Learning Objectives

Completion of this chapter will enable you to:

- Distinguish between a provision and a contingent liability under IFRS and summarize the differences under U.S. GAAP.
- Identify the differences in accounting for contracts, application of lower of cost or market inventory valuation and “events after the balance sheet date” under U.S. GAAP and IFRS.

Provisions, Contingent Liabilities and Contingent Assets

IAS 37, *Provisions, Contingent Liabilities and Contingent Assets*, provides the overall guidance for recognition and measurement criteria of provisions and contingencies under IFRS. There is no one standard as broad as IAS 37 in U.S. GAAP. FASB ASC 450 (formerly SFAS 5, *Accounting for Contingencies*), and a plethora of other statements deal with specific types of contingencies and provisions (e.g., FASB ASC 605 (formerly SFAS 48, *Revenue Recognition When Right of Return Exists*), and FASB ASC 410 (formerly SFAS 143, *Accounting for Asset Retirement Obligations*).

Provisions and Contingencies

Under IFRS, a provision is “a liability of uncertain timing or amount” (**IAS 37, ¶10**). Under IAS 37, an entity recognizes a provision when an entity (**IAS 37, ¶10**):

- Has a present obligation (legal or constructive) as a result of a past event;
- Will probably have an outflow of resources embodying economic benefits to settle the obligation; and
- Can make a reliable estimate of the amount of the obligation.

While FASB ASC 450 does not include a definition for a provision, it does define a contingency as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.” This definition is similar to IAS 37’s definition of a provision.

Furthermore, FASB ASC 450 requires an entity to recognize a contingent liability when:

- Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
- The amount of loss can be reasonably estimated (**FASB ASC 450-20-25-2**).

When taken with the definition of a contingent liability, the recognition criteria of FASB ASC 450 make the recognition of a contingent liability under FASB ASC 450 and the recognition of a provision under IAS 37, essentially the same.

Thus, a contingent liability under FASB ASC 450 is similar to a provision under IAS 37.

IAS 37—and IAS 10—defines a contingency as a:

- Possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- Present obligation that arises from past events but is not recognized because:
 - It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - The amount of the obligation cannot be measured with sufficient reliability.

An entity does not recognize a contingent liability; however, an entity must disclose a contingent liability unless the possibility of a negative outcome is remote.

Likelihood of Occurrence

Under FASB ASC 450, when a loss contingency exists, the likelihood that the future event will confirm the loss or impairment of an asset or the incurrence of a liability may range from probable to remote. The standard identifies three areas within that range. The areas are:

- Probable—likely to occur
- Remote—slight chance of occurring
- Reasonably possible—more than a remote chance of occurrence, but less than probable

As previously mentioned, an entity only recognizes a contingent liability if the likelihood of occurrence is *probable* and it can make a reasonable estimate of the amount.

A significant difference under IAS 37 is the meaning of “probable.” IAS 37 defines probable as “the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.” This means that the likelihood of occurrence needs only to be greater than 50% for an entity to recognize a provision.

Based on the differing definitions of probable, an entity is *more likely* to recognize a provision under IAS 37, than it would be to recognize a contingent liability under FASB ASC 450.

Measurement of Liability

U.S. GAAP requires the recognition of a contingent liability at a “reasonable estimate” of the amount to be paid. In some situations, U.S. GAAP requires an entity to measure a provision at fair value (e.g., asset retirement obligations).

Under IFRS, if there is an observable market value for the obligation, an entity must measure the provision using the observable market value. If an observable market value is unavailable, an entity recognizes the provision at the amount of the expenditure it expects to incur.

Large Homogenous Population

In the case of a large homogenous population (e.g., product warranties), under both U.S. GAAP and IFRS, an entity generally will measure the liability at its expected value, which considers all possible outcomes weighted based on their probabilities.

Range of Possible Outcomes

According to FASB ASC 450-20-25 and FASB ASC 450-20-30 (formerly FASB Interpretation 14, *“Reasonable Estimation of the Amount of a Loss an interpretation of FASB Statement No. 5),”* when it is probable that an asset has been impaired or a liability has been incurred and the estimated amount of loss is within a range of amounts, some amount of loss has been incurred and should be accrued. When some amount within the range is a better estimate than any other amount within the range, an entity will accrue that amount. However, when no amount within the range is a better estimate than any other amount, an entity will recognize the minimum amount in the range.

IAS 37 differs from U.S. GAAP in that an entity would accrue the mid-point of the range, rather than the minimum amount.

Discounting Provisions

Under IFRS, an entity recognizes a provision at the estimated amount to settle or transfer the obligation taking into consideration the time value of money. The entity uses a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the liability. (IAS 37, ¶4)

U.S. GAAP generally does not allow entities to discount liabilities. An entity may only discount a liability when the amount of the liability and the timing of the payments are fixed or reliably determinable, or when the obligation is a fair value obligation (e.g., an asset retirement obligation or an environmental remediation liability). Unlike IFRS, an entity would discount these liabilities using a risk-free rate.

Disclosures for Non-accrued Items

Unless the possibility of loss is remote, IAS 37 requires an entity to disclose for each class of contingent liability, a brief description of the nature of the contingent liability and, if possible:

- An estimate of its financial effect,
- An indication of the uncertainties relating to the amount or timing of any outflow, and
- The possibility of any reimbursement.

Under FASB ASC 450, if an entity does not accrue a loss contingency because one or both of the conditions for accrual are not met, or if the loss may be more than the amount accrued, the entity must disclose the contingency when there is at least a reasonable possibility that a loss or an additional loss may be incurred. The disclosure will indicate the nature of the contingency and provide an estimate of the possible loss or range of loss or state that such an estimate is impossible to make.

Another difference in U.S. GAAP and IFRS disclosures is that IFRS permits a reduced disclosure if disclosure would be severely prejudicial to an entity's position in a dispute with another party to a contingent liability. U.S. GAAP has no similar provision.

Restructuring Costs

IAS 37 covers a restructuring program, which is “a program that is planned and controlled by management, and materially changes either the:

- Scope of a business undertaken by an entity; or
- Manner in which that business is conducted.”

FASB ASC 420 (formerly SFAS 146, *Accounting for Costs Associated with Exit or Disposal Activities*), states that “exit activities” is not limited to only “restructuring” as defined in IAS 37. Thus, FASB ASC 420 includes a wider range of activities than IAS 37. **(FASB ASC 420-10-05)**

IAS 37 applies to restructuring costs once management is demonstrably committed to a detailed exit plan. That is, once management has a constructive or legal obligation.

FASB ASC 420 divides restructuring costs into three types of costs (IAS 37 does not):

- One-time termination benefits
- Contract termination costs, and
- Other associated costs.

Generally, an entity is able to recognize restructuring costs earlier under IFRS than under U.S. GAAP because IAS 37 focuses on the exit plan as a whole, rather than the individual cost components like FASB ASC 420.

Convergence

Both the FASB and the IASB have current agenda projects dealing with this topic. The IASB issued an exposure draft in October 2005 and the FASB in June 2008. The IASB has indicated its intent to converge with U.S. GAAP in the accounting for restructuring costs as part of the project.

Revenue Recognition

In many ways, similar philosophies provide the foundation for revenue recognition under IFRS and U.S. GAAP. Revenue recognition under both U.S. GAAP and IFRS is tied to the completion of the earnings process and the realization of assets from such completion. Under both standards, an entity will recognize revenue when it is realized (or realizable) and earned. In the end, both standards base revenue recognition on the transfer of risks and both attempt to determine when the earnings process is complete.

U.S. GAAP provides very stringent revenue recognition guidance, including FASB ASC 605 (formerly Technical Bulletin 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, and ARB 45, *Long-Term Construction-Type Contracts*), FASB ASC 360 (formerly SFAS 66, *Accounting for Sales of Real Estate*), and FASB ASC 985 (formerly AICPA SOP 97-2, *Software Revenue Recognition*). These standards often prescribe industry-specific accounting. On the other hand, IFRS has just two primary revenue standards (IAS 11, *Construction Contracts*, and IAS 18, *Revenue*) and a few revenue related interpretations (e.g., SIC 31, *Revenue—Barter Transactions Involving Advertising Services*, and IFRIC 4, *Determining whether an Arrangement contains a Lease*) that capture all revenue transactions.

Agent versus Principal

Under both IFRS and U.S. GAAP, amounts collected on behalf of the principal by the agent are not revenue to the agent. The revenue of the agent is the amount of commission, plus any other amounts charged by the agent to the principal or other parties.

GAAP: FASB ASC 605-45-45 (formerly EITF 99-19, *Reporting Revenue Gross as a Principal versus Net as an Agent*), provides eight indicators as to when an entity should report revenue at gross (principal). They are, when the entity:

- Is the primary obligor in the arrangement,
- Has general inventory risk,
- Has latitude in establishing price,
- Changes the product or performs part of the service,
- Has discretion in supplier selection,
- Is involved in the determination of product or service specifications,
- Has physical loss inventory risk, and
- Has credit risk.

Additionally, FASB ASC 605-45-45 includes three indicators as to when an entity should report revenues net (agent). They are the:

- Supplier is primary obligor in the arrangement,
- Amount that the entity earns is fixed, and
- Supplier has credit risk.

These indicators are not presumptive or determinative. Judgment is required to determine whether gross or net presentation is appropriate.

IFRS: While IFRS 18 does not have the number of indicators as U.S. GAAP, it does provide four indicators that an entity is acting as a principal. The indicators are that the entity:

- Has the primary responsibility for providing the goods or services to the customer or for fulfilling the order,
- Has inventory risk before or after the customer order, during shipping or on return,
- Has latitude in establishing prices, either directly or indirectly, for example by providing additional goods or services, and
- Bears the customer's credit risk for the amount receivable from the customer.

An entity is acting as an agent when it does not have exposure to the significant risks and rewards associated with the sale of goods or rendering of services.

Because U.S. GAAP and IFRS only have indicators, and not criteria, for determining agent or principal and not the same indicators, practice may vary.

Merchandise Sales

IFRS and U.S. GAAP have similar criteria for recognizing revenue from sales of merchandise. Under IFRS, the seller recognizes revenue only when:

- The risks and rewards of ownership are transferred from the seller to the buyer,
- The buyer has control of the goods,
- Revenues can be measured reliably, and
- It is probable that the economic benefits will flow to the company.

The U.S. GAAP found in FASB ASC 605-10-S99 (formerly Staff Accounting Bulletin 104, *Revenue Recognition*), requires that for a public entity to recognize revenue:

- Delivery has occurred (the risks and rewards of ownership have been transferred),
- There is persuasive evidence of the sale,
- The fee is fixed or determinable, and
- Collectability is reasonably assured.

Because the criteria for recognizing revenue on a sale of merchandise are not exactly the same under IFRS and U.S. GAAP and because of specialized standards (e.g., software, motion pictures) differences in the timing and amount of revenue recognition on sales of merchandise may arise.

The general guidance for revenue recognition for nonpublic entities is found in SFAC 5, *Recognition and Measurement in Financial Statements of Business Enterprises*.

Sales When a Right of Return Exists

IFRS and U.S. GAAP handle sales when the buyer has the right to return the merchandise in a similar manner, but with some differences. FASB ASC 605-15-25 (formerly SFAS 48, *Revenue Recognition When the Right of Return Exists*), lists six conditions that must be met for an entity to recognize revenue when the buyer has the right to return the merchandise. IFRS states that if there is uncertainty about the possibility of return, revenue is recognized when the buyer formally accepts the merchandise or the merchandise has been delivered and the time period for rejection has elapsed. However, if the seller can make a reliable estimate of the amount of expected returns, revenue is recognized along with a provision for the expected returns.

Construction Contracts

Types of Contracts

U.S. GAAP on construction contracts primarily is in FASB ASC 505 and FASB ASC 605 (formerly ARB 43, *Restatement and Revision of Accounting Research Bulletins*, and ARB 45, *Long-term Construction Type Contracts*). There are four types of contracts in U.S. GAAP:

- Fixed price
- Cost-plus
- Time-and-material
- Units-of-production

IAS 11 only has two classifications of contracts; fixed price contracts and cost-plus contracts.

Revenue Recognition on Construction Contracts

The preferred method of accounting for construction contracts under both sets of standards is the percentage of completion method. IAS 11 has two criteria that must be met for an entity to use the percentage of completion method:

- The outcome of the contract can be reliably estimated, and
- The stage of completion of the contract is reliably measureable.

FASB ASC 605-35-25 has the same two criteria as IAS 11 plus two additional criteria for the percentage of completion method to be applicable. The additional criteria are:

- Contracts have been executed and the contracts include enforceable rights concerning goods or services to be delivered, the consideration, and the manner and terms of settlement, and
- The buyer and contractor are expected to satisfy/perform their obligations under the contract.

While these two criteria may be relevant under IFRS, there is no explicit requirement to consider them, so differences between IFRS and U.S. GAAP may arise which could result in an earlier recognition of revenue under IFRS.

If the criteria for percentage of completion are not met, U.S. GAAP *requires* an entity to use the completed contract method. IAS 11 does not allow the completed contract method. If an entity is not able to meet the criteria for using the percentage of completion, revenue recognition is limited to recoverable costs incurred (i.e., the cost recovery method).

Both sets of standards require immediate recognition of an expected loss on a contract.

Other Contract Differences

Segmenting Contracts

IFRS *require* the combining or segmenting of contract components if the contracts meet certain criteria; whereas, U.S. GAAP allows, but does not require, the combining or segmenting of contracts if they meet certain criteria.

Learning Curve or Start-up Costs

IFRS provides no guidance on the accounting for “learning curve” or “start-up” costs; whereas, U.S. GAAP requires expensing the costs as incurred, unless the costs are incurred under existing construction contracts and in anticipation of follow-on or future construction contracts for the same goods or services, in which case the costs are charged to existing and future contracts.

Combining Construction Contracts

Both GAAPs allow the combining of construction contracts when the contracts meet certain conditions; however, IFRS and U.S. GAAP do not have the same conditions, which could result in the combining of contracts under IFRS and not U.S. GAAP.

Bill and Hold Transactions

Under IFRS, the seller recognizes revenue on a bill and hold transaction when the buyer has taken title and four additional criteria are met:

1. It is probable that delivery will be made,
2. The item is on hand, identified and ready for delivery to the buyer,
3. The buyer acknowledges the deferred delivery instructions, and
4. The usual payment terms apply.

U.S. GAAP for public entities specifies seven criteria the transaction must meet for the seller to recognize revenue on a bill and hold transaction.

1. The risks of ownership must have passed to the buyer,
2. The customer has made a fixed commitment to purchase the goods,
3. The buyer requests that the transaction be on a bill and hold basis. The buyer must have a substantial business purpose for ordering the goods on a bill and hold basis;
4. There must be a fixed schedule for delivery of the goods. The date for delivery must be reasonable and must be consistent with the buyer's business purpose (e. g., storage periods are customary in the industry);
5. The seller has not retained any specific performance obligations such that the earning process is not complete;
6. The ordered goods must have been segregated from the seller's inventory and not be subject to being used to fill other orders; and
7. The product must be complete and ready for shipment.

While the seven criteria in U.S. GAAP may be relevant under IFRS; since there is no explicit requirement to consider them, differences may arise in practice with revenue being recognized later under U.S. GAAP. For nonpublic entities, there is no specific U.S. GAAP on bill and hold transactions; however, nonpublic entities may find the guidance in SAB 13 helpful.

Miscellaneous Revenue Issues

Service Contracts

U.S. GAAP addresses certain types of service revenue, primarily relating to services sold with software. All other service revenue should follow FASB ASC 605-10-S99 (formerly Staff Accounting Bulletin 104, *Revenue Recognition*). Application of long term contract accounting FASB ASC 605-35-15 (formerly SOP 81-1, *Accounting for Performance of Construction-Type and Certain Production-Type Contracts*) is not permitted for non-construction services. Possible revenue recognition methods include the proportional performance method, the straight-line method, or recognition upon completion of all related services.

Under IAS 11, whenever an entity can reliably measure revenues and costs, and it is probable that economic benefits will flow to the company, the entity will generally recognize revenue using the percentage of completion method following the same principles as for construction contracts.

Multiple Element Transactions

IFRS provide little guidance in accounting for multiple element transactions (e.g., when an entity sells goods with future support at no additional charge). IAS 18 requires an entity to recognize revenue on an element of a transaction if that element has commercial substance on its own; otherwise, the entity accounts for the separate elements as a single transaction. IAS 18 does not provide specific criteria for making that determination.

Unlike IFRS, under U.S. GAAP a multiple-element transaction must meet specific criteria for each element to be a separate unit of accounting. The criteria are (**FASB ASC 605-25-25**):

- Delivered elements that must have standalone value,
- Undelivered elements that must have reliable and objective evidence of fair value, and
- Delivery or performance of the undelivered item or items is considered probable and substantially in the control of the vendor

If the transaction meets these criteria, the entity recognizes revenue for each element of the transaction when the element is complete.

Software Revenue

IFRS provide no specific guidance on software-related transactions. Unlike IFRS, U.S. GAAP provides specific guidance on revenue recognition for software and software-related deliverables. The more specific guidance could result in the recognition of revenue under U.S. GAAP after IFRS.

Real Estate Development

Normally, an entity will treat sales of real estate like sales of goods under IFRS. Again, U.S. GAAP has specific, detailed criteria that must be met for an entity to recognize revenue from the sale of real estate. When these conditions are not met, the seller accounts for the proceeds as deposits until the criteria are met at which time the percentage of completion accounting method is applied to the sale.

Convergence

In late 2008, the FASB and IASB began a joint project to develop concepts for revenue recognition and a standard based on those concepts. The objective of the project is to clarify the principles for recognizing revenue and to create a joint revenue recognition standard for IFRS and U.S. GAAP that entities can apply consistently across various industries and transactions. By developing a common standard that clarifies the principles for recognizing revenue, the boards aim to:

- Remove inconsistencies and weaknesses in existing revenue recognition standards and practices,
- Provide a more robust framework for addressing revenue recognition issues,
- Simplify the preparation of financial statements by reducing the number of standards to which companies must refer,
- Improve comparability of revenue across companies and geographical boundaries.

The Boards plan to issue a final document on revenue recognition in 2011.

Miscellaneous Topics

This section covers multiple, unrelated topics where differences between IFRS and U.S. GAAP exist.

Segment Reporting

On November 30, 2006, as part of the short-term convergence project, the IASB adopted IFRS 8, *Operating Segments*, to replace IAS 14, *Segment Reporting*. IFRS 8 eliminated the majority of differences between U.S. GAAP FASB ASC 280 (formerly SFAS 131, *Disclosures about Segments of an Enterprise and Related Information*) and IFRS by converging with the requirements of FASB ASC 280. With the adoption of IFRS 8, only limited differences remain between the two standards.

Matrix Approach or Management Approach

Many entities have a “matrix” form of organization. What this means is that in some entities, some managers have responsibility for different product and service lines worldwide, while other managers have responsibility for specific geographic areas. The chief operating decision maker (CODM) frequently reviews the operating results of both components, and financial information is available for both. In that situation, the components based on products and services would constitute the operating segments.

Other entities may use the management approach. The management approach is based on the way management organizes the entity’s segments for making operating decisions and assessing performance. As a result, the segments are evident from the structure of the entity’s internal organization, and financial statement preparers are able to provide the required information in a cost-effective and timely manner.

Under FASB ASC 280, entities that use a matrix determine segments based on products and services. Under IFRS 8, all entities determine segments based on the management approach, regardless of the form of organization. Therefore, if an entity using U.S. GAAP does not use a matrix approach there is no difference between the determination of segments under FASB ASC 280 and IFRS 8.

Disclosure of Liabilities

Under U.S. GAAP, an entity does not disclose segment liabilities in the segment information even if the liabilities are reported to the CODM. However, under IFRS if liabilities routinely are reported to the CODM, the segment liabilities are a required disclosure.

Inventory

FASB ASB 330-10 (formerly ARB 43, *Restatement and Revision of Accounting Research Bulletins*, Chapter 4, *Inventory Pricing*), and IAS 2, *Inventories*, are the primary sources for inventory accounting. According to both sets of standards, the primary basis of accounting for inventory is cost. Both define inventory as assets held for sale in the ordinary course of business, in the process of production for such sale, or to be used in the production of goods or services.

IFRS and U.S. GAAP agree that the cost of inventory includes all direct expenditures necessary to get it ready for sale, including applicable overhead charges; however, inventory cost excludes selling costs, general administrative costs, and most storage costs. U.S. GAAP contains no guidance on the treatment of storage and holding costs, while under IFRS an entity would generally expense the costs unless the costs are necessary before a further stage of production, the inventory is a discrete project, or the inventory requires a maturation process. This could give rise to a difference in inventory valuation.

IAS 2 includes asset retirement obligations (AROs) arising during the production of inventory in the cost of inventory; whereas, U.S. GAAP excludes AROs from inventoriable costs, but adds the AROs to the carrying value of the related property, plant and equipment.

Inventory Valuation

Under IAS 2, an entity must use the same inventory valuation method (e.g., FIFO) for all inventories having a similar nature and use to the entity. Under U.S. GAAP there is no such requirement.

Lower-of-cost or Market (Net Realizable Value)

The two sets of standards differ in the measurement of inventory. Under IFRS, entities generally measure inventories at the lower of cost or ***net realizable value***. However, under U.S. GAAP entities generally measure inventories at the lower of cost or ***market***.

Under IFRS, net realizable value is the best estimate of the amounts inventories are expected to realize, taking into consideration the purpose for which the inventory is held (this amount may or may not equal fair value).

U.S. GAAP defines market as current replacement cost as long as market is less than or equal to net realizable value (estimated selling price less reasonable costs of completion and sale) and is not less than net realizable value reduced by a normal sales margin.

U.S. GAAP requires an entity to recognize any write-down in inventory value cost of goods sold. IFRS require the write-down to be recognized as an expense, but they do not specify in which line item to include the write-down.

If an entity writes down the net realizable value of an item under IAS 2, then the entity ***would recognize*** any subsequent increases in net realizable value. Under U.S. GAAP, entities ***do not recognize*** subsequent increases in market value after a write-down.

Recognizing Inventory in Excess of Cost

In limited circumstances, both U.S. GAAP and IFRS allow measuring inventory at net realizable value even if it is higher than cost. IAS 2 allows producers' inventories of agricultural and forest products and mineral ores and for broker-dealers' inventories of commodities to be written-up to net realizable value in excess of cost.

U.S. GAAP limits write-ups based on specific products (e.g., precious minerals).

Last-in, First-out Inventory Costing

A major lack of convergence between U.S. GAAP and IFRS is with the last-in, first-out (LIFO) costing method. LIFO is an acceptable method under U.S. GAAP. IFRS prohibits the use of the LIFO costing method. Both sets of standards allow the use of the first-in, first-out (FIFO) and weighted average methods.

An added complication for entities filing U.S. tax returns is the tax requirement that an entity using LIFO for tax purposes, must use LIFO for financial reporting purposes, something that is not possible under IFRS.

Events after the Balance Sheet Date

IAS 1, *Presentation of Financial Statements*, and IAS 10, *Events after the Reporting Period*, are the IFRS covering events after the balance sheet date. The standards require an entity to adjust the financial statements for events that occur after the balance sheet date and *before the financial statements are authorized for issue*, if the events provide evidence of conditions that *existed at the reporting date*. As usual, there are a number of U.S. standards affecting the reporting of events after the balance sheet date (e.g., FASB ASC 260 (formerly SFAS 128, *Earnings per Share*, and FASB ASC 740 (formerly FIN 48, *Accounting for Uncertainty in Income Taxes*). The difference between U.S. GAAP and IFRS is that U.S. GAAP would adjust for an event occurring prior to the issuance of the financial statements, not the date the financial statements are authorized for issue.

IAS 1 and 10 do not allow the adjusting of financial statements for items occurring after the reporting date except when the going concern assumption is no longer appropriate. U.S. GAAP is similar to IFRS, except there is no exception for the going concern assumption. Also, unlike IFRS, FASB ASC 505-10-S99 (formerly SAB Topic 4-C, *Change in Capital Structure*), requires SEC registrants to adjust the balance sheet for a share dividend, share split (or reverse split) occurring after the reporting date.

Under IFRS, liabilities existing at the reporting date are classified as current or non-current based on the circumstances existing at that date. Whereas, under U.S. GAAP post-reporting date refinancing are considered in determining the classification of debt at the reporting date. Also, liabilities payable on demand at the reporting date because of covenant violations may be classified as non-current in certain circumstances.

In addition, IFRS allow adjusting the financial statements to reflect subsequent information that becomes available about tax uncertainties existing at the reporting date, whereas, U.S. GAAP does not.

For Type II events, IFRS specify disclosures the entity must make (nature of the event and estimate of the financial effect). U.S. GAAP has no specific disclosures.

Changes in Accounting Policies and Estimates, and Corrections of Errors

Both sets of standards have an impracticability exemption for the retrospective application of changes in accounting policy. IFRS also applies the exemption to changes in accounting estimates, whereas under U.S. GAAP the exemption only applies to changes in accounting policy.

IFRS allow an entity to choose whether to adjust comparatives for common control transactions. U.S. GAAP requires an entity to adjust for common control transactions.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

37. On November 5, 20X9, an employee filed a €2,000,000 lawsuit against M&M Co. for damages suffered when one of M&M's factories exploded on December 23, 20X9. M&M's lawyers fully expect the company will lose the lawsuit and estimate the loss to be between €500,000 and €1,000,000, with no one outcome being assessed as more likely than any other. The employee has offered to settle the lawsuit out of court for €900,000, but M&M plans to litigate. What amount would M&M recognize related to the lawsuit in the 20X9 financial statements under U.S. GAAP?
- a. €0.
 - b. €500,000.
 - c. €750,000.
 - d. €1,000,000.
38. On November 5, 20X9, an employee filed a €2,000,000 lawsuit against M&M Co. for damages suffered when one of M&M's factories exploded on December 23, 20X9. M&M's lawyers fully expect the company will lose the lawsuit and estimate the loss to be between €500,000 and €1,000,000, with no one outcome being assessed as more likely than any other. The employee has offered to settle the lawsuit out of court for €900,000, but M&M plans to litigate. What amount would M&M recognize related to the lawsuit in the 20X9 financial statements under IAS 37?
- a. €0.
 - b. €500,000.
 - c. €750,000.
 - d. €1,000,000.
39. Which one of the following is **not** a classification of construction contracts under IFRS?
- a. Fixed price.
 - b. Time-and-material.
 - c. Cost-plus contracts.
40. Which one of the following is included in inventory costs under U.S. GAAP?
- a. Selling costs.
 - b. Applicable overhead charges.
 - c. Storage costs.
 - d. Asset retirement obligations.

41. IFRS require an entity to adjust the financial statements for events that occur after the balance sheet date and before:
- a. The financial statements are issued.
 - b. The financial statements are authorized for issue.
 - c. The books are closed for the period.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

37. On November 5, 20X9, an employee filed a €2,000,000 lawsuit against M&M Co. for damages suffered when one of M&M's factories exploded on December 23, 20X9. M&M's lawyers fully expect the company will lose the lawsuit and estimate the loss to be between €500,000 and €1,000,000, with no one outcome being assessed as more likely than any other. The employee has offered to settle the lawsuit out of court for €900,000, but M&M plans to litigate. What amount would M&M recognize related to the lawsuit in the 20X9 financial statements under U.S. GAAP? **(Page 109)**
- a. €0. [This answer is incorrect. Because the M&M is expected to lose the lawsuit, some amount must be accrued in the 20X9 financial statements.]
 - b. **€500,000.** [This answer is correct. Because M&M's expected loss is a range (€500,000 to €900,000), under U.S. GAAP M&M would accrue a liability for the minimum amount in the range.]
 - c. €750,000. [This answer is incorrect. While M&M must accrue some amount for the loss, the amount to be accrued under U.S. GAAP is not the mid-point of the range (€500,000 to €900,000).]
 - d. €1,000,000. [This answer is incorrect. While M&M must accrue some amount for the loss, the amount to be accrued under U.S. GAAP is not the maximum possible loss.]
38. On November 5, 20X9, an employee filed a €2,000,000 lawsuit against M&M Co. for damages suffered when one of M&M's factories exploded on December 23, 20X9. M&M's lawyers fully expect the company will lose the lawsuit and estimate the loss to be between €500,000 and €1,000,000, with no one outcome being assessed as more likely than any other. The employee has offered to settle the lawsuit out of court for €900,000, but M&M plans to litigate. What amount would M&M recognize related to the lawsuit in the 20X9 financial statements under IAS 37? **(Page 109)**
- a. €0. [This answer is incorrect. Because the M&M is expected to lose the lawsuit, some amount must be accrued in the 20X9 financial statements.]
 - b. €500,000. [This answer is incorrect. Because M&M's expected loss is a range (€500,000 to €1,000,000), under IAS 37 M&M will accrue a liability, but not for the minimum amount in the range.]
 - c. **€750,000.** [This answer is correct. M&M will accrue the loss and the amount to be accrued under IAS 37 is the mid-point of the range (€500,000 to €1,000,000).]
 - d. €1,000,000. [This answer is incorrect. While M&M must accrue some amount for the loss, the amount to be accrued under IAS 37 is not the maximum possible loss.]

39. Which one of the following is **not** a classification of construction contracts under IFRS? **(Page 112)**

- a. Fixed price. [This answer is incorrect. One of the two contract classifications under IFRS is fixed price contracts.]
- b. Time-and-material. [This answer is correct. Time-and-material contracts is one of the contract classifications under U.S. GAAP, but not under IFRS.]**
- c. Cost-plus contracts. [This answer is incorrect. Cost-plus contracts is one of the two contract classifications under IFRS.]

40. Which one of the following is included in inventory costs under U.S. GAAP? **(Page 117)**

- a. Selling costs. [This answer is incorrect. Selling costs are not inventoriable costs under U.S. GAAP. Both IFRS and U.S. GAAP exclude selling costs from inventoriable costs.]
- b. Applicable overhead charges. [This answer is correct. Overhead charges applicable to inventory are inventoriable costs.]**
- c. General administrative costs. [This answer is incorrect. General administrative costs are not inventoriable costs under U.S. GAAP or IFRS.]
- d. Asset retirement obligations. [This answer is incorrect. U.S. GAAP excludes AROs from inventoriable costs, but adds the AROs to the carrying value of the related property, plant and equipment. However, IAS 2 includes asset retirement obligations (AROs) arising during the production of inventory in the cost of inventory.]

41. IFRS require an entity to adjust the financial statements for events that occur after the balance sheet date and before: **(Page 118)**

- a. The financial statements are issued. [This answer is incorrect. U.S. GAAP requires adjustments for events that occur after the balance sheet date and before the financial statements are issued; however, IFRS has a different cut-off date.]
- b. The financial statements are authorized for issue. [This answer is correct. This is the cut-off date for IFRS. IFRS require adjustments for events that occur after the balance sheet date and before the financial statements are authorized for issue.]**
- c. The books are closed for the period. [This answer is incorrect. The closing of the books has no effect on the reporting of events after the reporting date.]

EXAMINATION FOR CPE CREDIT

Chapter 7

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

33. On February 5, 20X0, an employee filed a €5,000,000 lawsuit against Clark Company for damages suffered when one of Clark's plants burned on November 3, 20X9. If the case goes to trial, Clark's lawyers expect the company will probably lose. Clark's lawyers expect the loss to be between €2,000,000 and €4,000,000; however, the employee has offered to settle the lawsuit out of court for €2,500,000; Clark's lawyers are expecting Clark to settle the lawsuit out of court. What amount would Clark recognize related to the lawsuit in the 20X9 financial statements under U.S. GAAP?
- a. €0.
 - b. €2,000,000.
 - c. €2,500,000.
 - d. €4,000,000.
34. On January 5, 20X0, an employee filed a €9,000,000 lawsuit against Campbell Corporation for damages suffered when one of Campbell's buildings exploded on October 23, 20X9. Campbell's lawyers feel it is more likely than not that the company will lose the lawsuit. The lawyers estimate that Campbell will lose between €5,000,000 and €8,000,000, with no one amount being more likely than any other amount. What amount will Clark recognize related to the lawsuit in the 20X9 financial statements under IAS 37?
- a. €0.
 - b. €5,000,000.
 - c. €6,500,000.
 - d. €8,000,000.
35. Which of the following statements is true concerning the segmenting of contracts under IFRS and U.S. GAAP?
- a. When certain conditions are met, IFRS allows the segmenting of contracts and U.S. GAAP requires the segmenting of contracts.
 - b. When certain conditions are met, both standards require the segmenting of contracts.
 - c. Neither set of standards allow the segmenting of contracts.
 - d. When certain conditions are met, IFRS require the segmenting of contracts and U.S. GAAP allows the segmenting of contracts.

36. Which one of the following methods is **not** acceptable under IFRS?
- a. LIFO.
 - b. FIFO.
 - c. Weighted average.
 - d. Lower of cost or realizable value.
37. Events affecting debt occurring after the reporting date may affect the classification of liabilities under:
- a. U.S. GAAP, but not IFRS.
 - b. IFRS, but not U.S. GAAP.
 - c. Both U.S. GAAP and IFRS.
 - d. Neither U.S. GAAP, not IFRS.

Chapter 8: Financial Instruments and First-Time Adoption of IFRS

Introduction

This chapter contrasts the principal issues related to financial instruments as found in official pronouncements of the IASB with those of U.S. GAAP. It also summarizes the issues related to the first-time adoption of IFRS.

Learning objectives

Completion of this chapter will enable you to:

- Identify the positions taken by the IASB and contrast with the positions taken by the FASB with respect to financial instruments.
- List the requirements for an entity's first-time adoption of IFRS.

Financial Instruments—Part A

This and the next subchapter address the major differences between IFRS and U.S. GAAP with respect to financial instruments. However, it does not address all of differences in all of the intricate details. This is intended to be a summary of the major-issue differences with respect to financial instruments, including derivatives, but not all of the differences of the minute details.

The principal pronouncements of the IASB that address financial instruments are: IAS 32, *Financial Instruments: Presentation*, IAS 39, *Financial Instruments: Recognition and Measurement*; and IFRS 7, *Financial Instruments: Disclosures*. In addition, in April 2009 the IASB issued *Improvements to IFRS* that modifies certain items related to financial instruments. The FASB Codification has numerous sections that relate wholly or in part to financial instruments. Some of the most wide-reaching are: FASB ASC 825 (formerly SFAS 107, *Disclosures about Fair Value of Financial Instruments*); FASB ASC 310 (formerly SFAS 114, *Accounting by Creditors for Impairment of a Loan*); FASB ASC 320 (formerly SFAS 115, *Accounting for Certain Investments in Debt and Equity Securities*); FASB ASC 815 (formerly SFAS 133, *Accounting for Derivative Instruments and Hedging Activities*); FASB ASC 860 (formerly SFAS 140, *Accounting for the Transfers and Servicing of Financial Assets and Extinguishments of Liabilities*); FASB ASC 480 (formerly SFAS 150, *Accounting for Certain Financial Instruments with Characteristics of both Liabilities and Equity*); and FASB ASC 820 (formerly SFAS 157, *Fair Value Measurements*).

Financial Assets Defined

IAS 32 defines a financial asset as any asset that is—

- a. Cash;
- b. An equity instrument of another entity;
- c. A contractual right to:
 - Receive cash or another financial asset from another entity; or
 - Exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or

- d. A contract that will or may be settled in the entity's own equity instruments and is a:
- Non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - Derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. **(IAS 32, ¶11)**

Items (a), (b), and (c) are quite similar to U.S. GAAP. However, the definition of a financial asset under U.S. GAAP does not address contracts that will or may be settled in the entity's own equity instruments. Thus, the definition of a financial asset is broader under IASB pronouncements than under U.S. GAAP.

Financial Liabilities Defined

IAS 32 defines a financial liability as a—

- a. Contractual obligation:
- to deliver cash or another financial asset to another entity; or
 - to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavorable to the entity; or
- b. Contract that will or may be settled in the entity's own equity instruments and is a:
- Non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - Derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments. **(IAS 32, ¶11)**

Item (a) is similar to U.S. GAAP. However, the definition of a financial liability under U.S. GAAP does not address contracts that will or may be settled in the entity's own equity instruments. Thus, the definition of a financial liability is broader under IASB pronouncements than under U.S. GAAP.

Classification of Financial Assets and Liabilities

IAS 39 classifies financial assets and liabilities into the following categories on initial recognition:

- At fair value through profit or loss,
- Held-to-maturity investments,
- Loans and receivables, or
- Available-for-sale financial assets.

In contrast, under U.S. GAAP, the classification of financial assets and liabilities generally is not specified with the exceptions of debt and marketable equity securities, which are classified as:

- Trading,
- Available for sale, or
- Held-to-maturity.

Measurement of Financial Assets and Liabilities

Under IFRS, loans and receivables and held-to-maturity investments are measured at amortized cost. All other financial assets and liabilities are measured initially at fair value, with limited exceptions. Under U.S. GAAP, derivatives, securities classified as trading or available-for-sale, and instruments which the entity per FASB ASC 825 has opted to measure at fair value are measured initially at fair value. Like IFRS, U.S. GAAP measures other financial instruments, including loans and receivables, at amortized cost. However, under U.S. GAAP, loans held for sale are measured at the lower of cost or market.

Under IFRS, a financial instrument may be measured at fair value upon initial recognition with unrealized gain and losses being included in net income only if certain criteria are met. In contrast, under U.S. GAAP, FASB ASC 825 allows entities essentially a free choice to designate most financial instruments, on an instrument-by-instrument basis, upon initial recognition at fair value with unrealized gains and losses being included in net income.

Derecognition of a Financial Asset

Under IFRS, the evaluation of whether a transfer of a financial asset qualifies for derecognition requires consideration of whether substantive risks and rewards and, in certain circumstances, control is transferred. Under IFRS, if an entity retains control of a financial asset for which some, but not substantially all, risks and rewards have been transferred, the entity continues to recognize the financial asset to the extent of its continuing involvement in the financial asset.

Under U.S. GAAP, a transfer is the conveyance of a non-cash financial asset by and to someone other than the issuer of that financial asset, which is similar to the position of IFRS. However, unlike IFRS, the derecognition model for transfers of financial assets focuses on surrendering control over the transferred assets. The transferor has surrendered control over the transferred assets only if certain conditions are met.

In addition, under U.S. GAAP, risks and rewards are not explicit considerations when testing a transfer for derecognition, but rather derecognition is based on whether legal, actual and effective control has been achieved.

Derecognition of a Financial Liability

Under both IFRS and U.S. GAAP, a financial liability is derecognized when it is extinguished.

Balance Sheet Presentation of Financial Assets

IFRS requires separate presentation on the balance sheet for each of the following classes of financial assets:

- Cash and cash equivalents,
- Trade and other receivables, and
- Investments in investees accounted for under the equity method.

An entity is not precluded from presenting additional line items of financial assets.

In contrast, U.S. GAAP does not require separate presentation of specific classes of financial assets. Nevertheless, actual practice is similar to the IFRS requirements.

Balance Sheet Presentation of Financial Liabilities

IFRS requires separate presentation on the balance sheet for each of the following classes of financial liabilities:

- Trade and other payables, and
- Provisions.

As in the case of financial assets, an entity is not precluded from presenting additional line items of financial liabilities.

U.S. GAAP does not have a similar requirement for the separate presentation on the balance sheet of financial liabilities.

Financial Instruments—Part B

Derivatives Defined

IAS 39 defines a derivative as a financial instrument or other contract within the scope of IAS 39 with all three of the following characteristics:

- a. Its value changes in response to the change in a specified interest rate, financial instrument price, commodity price, foreign exchange rate, index of prices or rates, credit rating or credit index, or other variable, provided in the case of a non-financial variable that the variable is not specific to a party to the contract (sometimes called the “underlying”);
- b. It requires no initial net investment or an initial net investment that is smaller than would be required for other types of contracts that would be expected to have a similar response to changes in market factors; and
- c. It is settled at a future date.

Items (a) and (b) are similar to U.S. GAAP. However, unlike IFRS, U.S. GAAP requires or permits net settlement for the financial instrument to qualify as a derivative. In addition, U.S. GAAP’s definition of a derivative specifies that the financial instrument or other contract must have one or more notional amounts, payment provisions, or both. IFRS does not have a notional amount or payment provision. These differences result in more financial instruments qualifying as derivatives under IFRS than under U.S. GAAP.

Embedded Derivatives

Under IAS 39, an embedded derivative is “a component of a hybrid (combined) instrument that also includes a non-derivative host contract-with the effect that some of the cash flows of the combined instrument vary in a way similar to a stand-alone derivative.” The definition of an embedded derivative is quite similar to U.S. GAAP. This basic definition was further clarified in the IASB’s *Improvements to IFRS* issued April 2009.

Under both IFRS and U.S. GAAP, derivatives embedded in host contracts generally are accounted for separately when their economic characteristics are not closely related to those of the host contract. However, “closely related” under IFRS differs from “clear and closely related” under U.S. GAAP in some respects.

Measurement of Derivatives

Under IFRS, all freestanding derivatives and certain embedded derivatives are recognized in the balance sheet and measured at fair value. Unless they qualify as hedging instruments in a cash flow or net investment hedge, all changes in fair value are recognized immediately in net income. Like IFRS, under U.S. GAAP, all freestanding derivatives and some embedded derivatives are recognized in the balance sheet and measured at fair value. Also, similar to IFRS, U.S. GAAP specifies that unless these derivatives qualify as hedging instruments in a cash flow or net investment hedge, all changes in fair value are recognized immediately in net income.

Hedge Accounting—Basic Position

U.S. GAAP and IFRS are similar with respect to hedging in that both utilize three different hedge accounting models, and the type of model applied depends on whether the hedged exposure is a fair value exposure, a cash flow exposure, or a currency exposure on a net investment in a foreign entity.

Fair Value Hedges

Definition

Under IFRS, a fair value hedge is “a hedge of the exposure to changes in fair value of a recognized asset or liability or an unrecognized firm commitment, or an identified portion of such an asset, liability or firm commitment, that is attributable to a particular risk and could affect profit or loss.” (**IAS 39, ¶86**) The definition of a fair value hedge under U.S. GAAP is quite similar to that of IFRS. However, FASB ASC 815 has more guidance on the concept of a firm commitment.

Measurement

Under both IFRS and U.S. GAAP, the hedging instrument is measured a fair value with changes in fair value recognized in net income. IFRS and U.S. GAAP both also require that the hedged item be remeasured to fair value with regard to the hedged risk even if normally it is measured at cost. For example, in the case of an interest rate swap used to hedge the change in the fair value of outstanding debt, the change in the fair value of the debt (the hedged item) would be remeasured to fair value with the unrealized gain or loss being included in net income. Under both U.S. GAAP and IFRS, if the outstanding debt were not the hedged item in a qualifying fair value hedge, it would be inappropriate to remeasure the debt to fair value.

Cash Flow Hedges

Definition

Under IFRS, a cash flow hedge is “a hedge of the exposure to variability in cash flows that (i) is attributable to a particular risk associated with a recognized asset or liability (such as all or some future interest payments on variable rate debt) or a highly probable forecast transaction and (ii) could affect profit or loss.” (**IAS 39, ¶86**) The definition of a cash flow hedge under U.S. GAAP is quite similar to that of IFRS.

Measurement

Under both IFRS and U.S. GAAP, a derivative hedging instrument is measured at fair value with the effective portion of changes in its fair value recognized directly in a separate component of equity, with any ineffectiveness being recognized in net income.

Under IFRS, if the hedging instrument is a non-derivative, gains and losses on the hedging instrument are recognized directly in equity. However, this treatment for non-derivatives is permitted only for hedges of foreign currency risk. Thus, in such case, the foreign currency gains and losses on the hedging instrument would be recognized directly in equity.

Similarly, under U.S. GAAP, if the hedging instrument is a non-derivative, gains and losses on the hedging instrument are recognized in equity. However, unlike IFRS, under U.S. GAAP, such treatment for non-derivatives is permitted only for hedges of foreign currency exposure of net investments in foreign operations.

Under both IFRS and U.S. GAAP, the gain or loss on the hedging instrument that is recognized directly in equity is transferred to (recognized in) net income when the future transaction affects net income. However, under U.S. GAAP, for cash flow hedges of forecasted transactions, no basis adjustments are allowed for non-financial assets or liabilities. Instead, the effective portion of the hedging instrument that is recognized directly in equity is transferred to net income when the future transaction affects net income.

Net Investment Hedges

Definition

Under both IFRS and U.S. GAAP, a net investment hedge is a hedge of the currency exposure of a net investment in a foreign operation using a derivative, or a non-derivative monetary item, as the hedging instrument. Also, under both, the hedged risk is the foreign currency exposure on the carrying amount of the net assets of the foreign operation in the consolidated financial statements.

Under IFRS, the hedged item may be all or a part of the carrying amount of a foreign operation at the beginning of any given period. Under U.S. GAAP, hedging a portion of the underlying net assets of a foreign operation is permitted. However, U.S. GAAP does not permit hedging a portion of the net investment.

Measurement

Under both IFRS and U.S. GAAP, the hedging instrument is measured at fair value. The effective portion of the gain or loss on the hedging instrument is recognized directly in equity, with any ineffectiveness being recognized in net income.

Under both IFRS and U.S. GAAP, when the net investment is sold, the cumulative amount of the translation reserve in equity is transferred to net income.

First-time Adoption of IFRS

An entity must apply IFRS 1, *First-time Adoption of International Financial Reporting Standards*, in:

- Its first IFRS financial statements; and
- Each interim financial report, if any, that it presents under IAS 34, *Interim Financial Reporting*, for part of the annual period covered by its first IFRS financial statements.

An Entity's First IFRS Financial Statements

An entity's first IFRS financial statements are "the first annual financial statements in which the entity adopts IFRS, by an explicit and unreserved statement in those financial statements of compliance with IFRS." IFRS 1 first applies when an entity first adopts IFRS. For example, under IFRS 1, financial statements under IFRS are an entity's first IFRS financial statements if, for example, the entity:

- Presented its most recent previous financial statements:
 - Under national requirements that are not consistent with IFRS in all respects;
 - In conformity with IFRS in all respects, except that the financial statements did not contain an explicit and unreserved statement that they complied with IFRS;
 - Containing an explicit statement of compliance with some, but not all, IFRS;
 - Under national requirements inconsistent with IFRS, using some individual IFRS to account for items for which national requirements did not exist; or
 - Under national requirements, with a reconciliation of some amounts to the amounts determined under IFRS;
- Prepared financial statements under IFRS for internal use only, without making them available to the entity's owners or any other external users;
- Prepared a reporting package under IFRS for consolidation purposes without preparing a complete set of financial statements as defined in IAS 1, *Presentation of Financial Statements*; or
- Did not present financial statements for previous periods.

Conversely, IFRS 1 does **not** apply when an entity:

- Stops presenting financial statements under national requirements, having previously presented them as well as another set of financial statements that contained an explicit and unreserved statement of compliance with IFRS; or
- Presented financial statements in the previous year under national requirements and those financial statements contained an explicit and unreserved statement of compliance with IFRS; or
- Presented financial statements in the previous year that contained an explicit and unreserved statement of compliance with IFRS, even if the auditors qualified their audit report on those financial statements.

Opening IFRS Statement of Financial Position

The opening IFRS statement of financial position is the starting point. The entity must present an opening IFRS statement of financial position at the date of transition to IFRS, which is the beginning of the earliest period for which full comparative information is presented in accordance with IFRS. For example, if an entity prepares IFRS financial statements for the two years ending December 31, 2012, the transition date would be January 1, 2011. Conversely, if an entity prepares IFRS financial statements for the three years ending December 31, 2012, the transition date would be January 1, 2010.

General Principles for Opening IFRS Statement of Financial Position

IFRS 1 requires that an entity use the same accounting policies in its opening IFRS statement of financial position and throughout all periods presented in its first IFRS financial statements except for certain exemptions allowed or required by IFRS 1.

IFRS 1 generally requires that the opening IFRS balance sheet:

- Includes all of the assets and liabilities that IFRS requires;
- Excludes any assets and liabilities that IFRS does not permit;
- Classifies all assets, liabilities, and equity in accordance with IFRS; and
- Measures all assets, liabilities, and equity in accordance with IFRS.

IFRS 1 requires that the general principles presented above be followed except where one of the options exemptions or mandatory exemptions does not require or permit recognition, classification and measurement in accordance with IFRS.

Consistent Application of Latest Version of IFRS

IFRS specifies that an entity should not apply different versions of IFRS that were effective at earlier dates. Rather, an entity may apply a new IFRS that is not yet mandatory if the IFRS permits early application.

Exemptions from Other IFRS

There are two categories of exemptions from IFRS described in IFRS 1:

- Exemptions *allowed* by IFRS 1
- Exemptions *required* by IFRS 1

Allowed Exemptions

IFRS 1 allows an entity to use one or more of the following exemptions:

- a. Business combinations,
- b. Fair value or revaluation as deemed cost,
- c. Employee benefits,
- d. Cumulative translation differences,
- e. Compound financial instruments,
- f. Assets and liabilities of subsidiaries, associates and joint ventures,
- g. Designation of previously recognized financial instruments,
- h. Share-based payment transactions,
- i. Insurance contracts,
- j. Decommissioning liabilities included in the cost of property, plant and equipment,
- k. Leases,
- l. Fair value measurements of financial assets or financial liabilities at initial recognition,
- m. Financial asset or an intangible asset accounted for in accordance with IFRIC 12, *Service Concession Arrangements*, and
- n. Borrowing costs.

Mandated Exemptions

IFRS 1 prohibits retrospective application of some aspects of other IFRS relating to:

- a. Derecognition of financial assets and financial liabilities,
- b. Hedge accounting,
- c. Estimates,
- d. Assets classified as held for sale and discontinued operations, and
- e. Some aspects of accounting for non-controlling interests.

Presentation and Disclosure

Comparative Information

IFRS 1 specifies that an entity's first IFRS financial statements must include at least three statements of financial position, two statements of comprehensive income, two separate income statements (if presented), two statements for cash flows and two statements of changes in equity and related notes, including comparative information. Thus, an entity that prepares IFRS financial statements for the first time for the two years ending December 31, 2016, must present comprehensive income statements, income statements (if presented separately), statements of cash flows, statements of changes in equity and related notes for 2015 and 2016, and statements of financial position at January 1, 2015, December 31, 2015, and December 31, 2016.

Non-IFRS Comparative Information and Historical Summaries

Assume that Entity A prepares IFRS financial statements for the first time for the two years ending December 31, 2016. It may choose, or be required by some regulatory agency, to present historical summaries of selected data for periods before the first period for which it presents full comparative information under IFRS. IFRS does not require for Entity A that such summaries prior to 2015 comply with the recognition and measurement requirements of IFRS. However, IFRS 1 would require Entity A to label any information presented for years prior to 2015 that is not in accordance with IFRS as not being prepared under IFRS and to disclose the nature of the main adjustments that would make it comply with IFRS; however, the Entity A would not have to quantify such adjustments.

Explanation of Transition to IFRS

IFRS 1 requires an entity to explain how the transition from previous GAAP (perhaps U.S. GAAP) to IFRS affected its reported financial position, financial performance and cash flows.

Reconciliations

- To comply with this requirement, an entity's first IFRS financial statements must include (IFRS 1, ¶39):
- Reconciliations of its equity reported under previous GAAP to its equity under IFRS for both of the following dates:
 - Date of transition to IFRS; and
 - End of the latest period presented in the entity's most recent annual financial statements under previous GAAP.
- A reconciliation to its total comprehensive income under IFRS for the latest period in the entity's most recent annual financial statements. The starting point for that reconciliation shall be total comprehensive income under previous GAAP for the same period or, if an entity did not report such a total, profit or loss under previous GAAP.
- If the entity recognized or reversed any impairment losses for the first time in preparing its opening IFRS statement of financial position, the disclosures that IAS 36, *Impairment of Assets*, would have required if the entity had recognized those impairment losses or reversals in the period beginning with the date of transition to IFRS.

Designation of Financial Assets or Financial Liabilities

IFRS 1 allows an entity to designate a previously recognized financial asset or financial liability as a financial asset or financial liability at fair value through net income or a financial asset as available for sale in accordance with IFRS 1. If it does, the entity must disclose the fair value of financial assets or financial liabilities designated into each category at the date of designation and their classification and carrying amount in the previous financial statements.

Use of Fair Value as Deemed Cost

Paragraph 16 of IFRS 1 allows an entity to remeasure an item of property, plant and equipment at the date of transition to IFRS at its fair value and use that fair value as its deemed cost at that date. If the entity chooses to use fair value in its opening statement of financial position as deemed cost for an item of property plant and equipment, an investments property or an intangible asset, the entity's first IFRS financial statements must disclose, for each line item in the opening IFRS statement of financial position, the aggregate:

- Of those fair values; and
- Adjustment to the carrying amounts reported under previous GAAP.

Interim Financial Reporting

If an entity presents an interim financial report, IFRS 1 requires the entity to make certain specific disclosures. Paragraphs 45–46 of IFRS 1 delineates those specific disclosures.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

42. Which of the following does **not** meet the definition of a financial asset under IAS 32?
- a. Cash.
 - b. An equity instrument of another entity.
 - c. A contractual right to receive cash or another financial asset from another entity.
 - d. A non-derivative from which the entity is or may be obliged to receive a fixed number of the entity's own equity instruments.
43. Under U.S. GAAP, the classification of financial assets and liabilities generally is not specified with the exception of debt and marketable equity securities. Which of the following is **not** one of the classifications used by U.S. GAAP for debt and marketable equity securities?
- a. Trading securities.
 - b. Available-for-sale securities.
 - c. Property, plant and equipment.
 - d. Held-to-maturity debt securities.
44. Under IFRS, in the case of a fair value hedge, the hedged instrument is remeasured to fair value with changes in fair value:
- a. Recognized in net income.
 - b. Recognized as a direct charge to equity.
 - c. Recognized as a prior period adjustment.
 - d. Not recognized.

45. Which of the following cases would **not** represent a situation in which an entity first applies IFRS?
- a. The entity generated financial statements under IFRS for internal use only and did not make them available to the entity's owners or any other external users.
 - b. For consolidation purposes only, the entity prepared a reporting package under IFRS without preparing a complete set of financial statements as defined in IAS 1, *Presentation of Financial Statements*.
 - c. In previous periods, the entity did not present financial statements.
 - d. The entity stops presenting financial statements under national requirements, having previously presented them as well as another set of financial statements that contained an explicit and unreserved statement of compliance with IFRS.
46. Which one of the following is **not** required in the opening IFRS balance sheet:
- a. In accordance with IFRS, the assets, liabilities, and equity are measured.
 - b. The classification of all assets, liabilities, and equity is done in accordance with IFRS.
 - c. Inclusion of all assets and liabilities that IFRS requires, but also all assets and liabilities required by U.S. GAAP.
 - d. The exclusion of any assets and liabilities that IFRS does not allow.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material. **(References are in parentheses.)**

42. Which of the following does **not** meet the definition of a financial asset under IAS 32? **(Page 126)**

- a. Cash. [This answer is incorrect. Under IAS 32, cash is a financial asset. It meets the definition of a financial asset, as defined in IAS 32. In fact, cash is the most liquid of all financial assets.]
- b. An equity instrument of another entity. [This answer is incorrect. Under IAS 32, an equity instrument of another entity is a financial asset. It meets the definition of a financial asset, as defined in IAS 32. Note that this must be an equity instrument of another entity rather than a debt instrument.]
- c. A contractual right to receive cash or another financial asset from another entity. [This answer is incorrect. Under IAS 32, a contractual right to receive cash or another financial asset from another entity is a financial asset. It meets the definition of a financial asset, as defined in IAS 32. Note that this definition does not include the right to pay cash or another financial instrument.]
- d. **A non-derivative from which the entity is or may be obliged to receive a fixed number of the entity's own equity instruments. [This answer is correct. The key in this case is that the entity is or may be obliged to receive a fixed number of the entity's own equity instruments. If the non-derivative had been one for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments, it would have qualified as a financial asset.]**

43. Under U.S. GAAP, the classification of financial assets and liabilities generally is not specified with the exception of debt and marketable equity securities. Which of the following is **not** one of the classifications used by U.S. GAAP for debt and marketable equity securities? **(Page 127)**

- a. Trading securities. [This answer is incorrect. Trading securities is one of the classifications used under U.S. GAAP. Trading securities are included on the balance sheet at fair value with unrealized gains and losses being included in the determination of net income.]
- b. Available-for-sale securities. [This answer is incorrect. Available-for-sale securities is one of the classifications used under U.S. GAAP. Available-for-sale securities are included on the balance sheet at fair value with unrealized gains and losses being included in other comprehensive income but not in net income.]
- c. **Property, plant and equipment. [This answer is correct. Property, plant and equipment is not one of the classifications used under U.S. GAAP for the classification of financial assets and liabilities. Property, plant and equipment represents long-term depreciable assets and land in use.]**
- d. Held-to-maturity debt securities. [This answer is incorrect. Held-to-maturity debt securities is one of the classifications used under U.S. GAAP. Held-to-maturity debt securities are reported at amortized cost rather than at fair value.]

44. Under IFRS, in the case of a fair value hedge, the hedged instrument is remeasured to fair value with changes in fair value: **(Page 130)**
- a. **Recognized in net income. [This answer is correct. The change in fair value of both the hedging instrument and the hedged instrument are recognized in net income. A perfect hedge, therefore, would have no effect on net income.]**
 - b. Recognized as a direct charge to equity. [This answer is incorrect. This is the appropriate treatment for a cash flow hedge, but not for a fair value hedge.]
 - c. Recognized as a prior period adjustment. [This answer is incorrect. Prior period adjustments are limited to corrections of errors.]
 - d. Not recognized. [This answer is incorrect. The change in fair value must be recognized.]
45. Which of the following cases would **not** represent a situation in which an entity first applies IFRS? **(Page 132)**
- a. The entity generated financial statements under IFRS for internal use only and did not make them available to the entity's owners or any other external users. [This answer is incorrect. If the entity did not make the "internal-use-only" statements available to the public, this would not preclude the current statements from qualifying as the entity's first application of IFRS.]
 - b. For consolidation purposes only, the entity prepared a reporting package under IFRS without preparing a complete set of financial statements as defined in IAS 1, *Presentation of Financial Statements*. [This answer is incorrect. If the entity prepared a reporting package under IFRS for consolidation purposes without preparing a complete set of financial statements, this would not preclude the current statements from qualifying as the entity's first application of IFRS.]
 - c. In previous periods, the entity did not present financial statements. [This answer is incorrect. If the entity did not present financial statements for previous periods, this would not preclude the current statements from qualifying as the entity's first application of IFRS.]
 - d. **The entity stops presenting financial statements under national requirements, having previously presented them as well as another set of financial statements that contained an explicit and unreserved statement of compliance with IFRS. [This answer is correct. IFRS 1 specifically identifies this situation as preventing financial statements of an entity from qualifying at the entity's first application of IFRS.]**
46. Which one of the following is **not** required in the opening IFRS balance sheet? **(Page 132)**
- a. In accordance with IFRS, the assets, liabilities, and equity are measured. [This answer is incorrect. This is a requirement for the opening balance sheet for IFRS.]
 - b. The classification of all assets, liabilities, and equity is done in accordance with IFRS. [This answer is incorrect. IFRS does require the classification of all assets, liabilities and equity in accordance with the IFRS guidance for the opening balance sheet.]
 - c. **Inclusion of all assets and liabilities that IFRS requires, but also all assets and liabilities required by U.S. GAAP. [This answer is correct. The opening balance sheet for the initial IFRS statement does not include requirements from U. S. GAAP.]**
 - d. The exclusion of any assets and liabilities that IFRS does not allow. [This answer is incorrect. To be in compliance on the opening balance sheet for IFRS, no assets or liabilities that IFRS does not allow can be included.]

EXAMINATION FOR CPE CREDIT

Chapter 8

Determine the best answer for each question below. Then log onto our Online Grading Center at **OnlineGrading.Thomson.com** to record your answers.

38. Which of the following is **not** of the four categories in which IAS 39 classifies all financial assets and liabilities?
- a. At fair value through profit or loss.
 - b. Held-to-maturity investments.
 - c. Loans and receivables.
 - d. Intangible assets.
39. Under U.S. GAAP, a freestanding derivative is measured at:
- a. Historical cost.
 - b. Amortized cost.
 - c. Its tax basis.
 - d. Fair value.
40. Smithson Whitehouse prepares IFRS financial statements for the first time for the two years ending December 31, 2016. For which dates must Smithson Whitehouse present statements of financial position?
- a. December 31, 2016 only.
 - b. December 31, 2016 and December 31, 2015.
 - c. December 31, 2016, December 31, 2015 and December 31, 2014.
 - d. January 1, 2015, December 31, 2015 and December 31, 2016.
41. Smithson Whitehouse prepares IFRS financial statements for the first time for the two years ending December 31, 2012. For which periods must Smithson Whitehouse present statements of comprehensive income?
- a. 2016 only.
 - b. 2015 and 2016.
 - c. 2016, 2015 and 2014.
 - d. 2016, 2015, 2014 and 2013.

Appendix

M&M Corporation
Statement of Financial Position
December 31, 20X9 and 20X8

	In thousands of euro	
	20X9	20X8
Assets		
Land	€ 147,364	€ 141,157
Building	653,751	598,852
Less: accumulated depreciation	(199,492)	(197,468)
Leased equipment	337,951	337,951
Less: accumulated depreciation	(101,385)	(67,590)
Furnishings and fixtures	128,470	128,470
Less: accumulated depreciation	(37,076)	(30,058)
Available for sale securities	32,507	25,057
Biological assets	150,000	120,000
Patents, net	52,105	58,584
Goodwill	21,560	28,456
Total non-current assets	1,185,755	1,143,411
Cash and cash equivalents	86,260	77,011
Trading securities	7,745	1,245
Accounts receivable	114,000	93,973
Inventories	153,954	109,886
Prepaid assets	23,232	30,788
Total current assets	385,191	312,903
Total assets	<u>€ 1,570,946</u>	<u>€ 1,456,314</u>
Equity		
Preferred stock	€ 20,000	€ 20,000
Paid-in capital in excess of par--preferred	2,811	2,811
Common stock	25,679	14,125
Paid-in capital in excess of par--common	30,871	11,286
Paid-in capital from treasury stock transactions	23,156	-
Paid-in capital from stock options	9,000	-
Retained earnings	549,823	492,004
Accumulated other comprehensive income:	2,910	-
	664,250	540,226
Less treasury stock (at cost)	-	2,843
Total equity	664,250	537,383
Liabilities		
Lease liability	217,763	243,421
Bonds payable	400,000	400,000
Defined benefit liability	2,600	-
Deferred income tax liability	107,915	93,575
Total non-current liabilities	728,278	736,996
Accounts payable	77,508	78,468
Dividends payable	11,124	10,031
Taxes payable	20,021	18,993
Interest payable	9,117	4,031
Other accrued liabilities	10,648	9,912
Notes payable	-	10,500
Current portion of lease liability	50,000	50,000
Total current liabilities	178,418	181,935
Total liabilities	906,696	918,931
Total equity and liabilities	<u>€ 1,570,946</u>	<u>€ 1,456,314</u>

M&M Corporation
Income Statements
For the Years Ended December 31, 20X9 and 20X8

	In thousands of euro	
	20X9	20X8
Continuing Operations		
Operating revenues and sales	€ 700,027	€ 606,088
Cost of goods sold	<u>339,300</u>	<u>266,772</u>
Gross profit	360,727	339,316
Other income:		
Gain on extinguishment of debt	-	(20,000)
Gain (loss) on trading securities	(6,500)	(210)
Depreciation and amortization	73,146	78,170
Goodwill impairment loss	6,896	-
Pension expense	16,000	-
Compensation expense	9,000	-
Other expenses:		
Interest expense	33,442	38,075
Loss from expropriation of land by a foreign government	-	10,000
Other operating expenses	<u>64,845</u>	<u>69,737</u>
Profit before tax	163,898	163,544
Income tax expense	<u>65,559</u>	<u>65,418</u>
Profit for the year from continuing operations	98,339	98,126
Discontinued Operations:		
Loss from discontinued operations (net of tax benefit of €97 in 20X9 and €507 in 20X8) (including loss on disposal of €1,174 in 20X9, net of tax benefit of €783)	<u>(1,319)</u>	<u>(761)</u>
Profit for the period	<u>€ 97,020</u>	<u>€ 97,365</u>
 Basic earnings per share		
Profit from continuing operations	€ 3.80	€ 5.80
Loss from discontinued operations	<u>(0.06)</u>	<u>(0.04)</u>
Profit for the period	<u>€ 3.74</u>	<u>€ 5.74</u>
 Diluted earnings per share		
Profit from continuing operations	€ 3.65	€ 5.80
Loss from discontinued operations	<u>(0.06)</u>	<u>(0.04)</u>
Profit for the period	<u>€ 3.59</u>	<u>€ 5.74</u>

M&M Corporation

Profit for the year
Other comprehensive income:
Change in underfunded pension liability
Unrealized gain on available-for-sale securities
Unrealized gain on available-for-sale securities
Total comprehensive income for the year

Note to financial statements

M&M Company

Change in underfunded pension liability
Unrealized gain on available-for-sale securities
Other comprehensive income

M&M Corporation
Statements of Changes in Stockholders' Equity
For the Years Ended December 31, 20X9 and 20X8
in thousands of euro

	Preferred Stock	Common Stock	Additional Paid-in Capital	Retained Earnings	Pension Liability	Available-for- Sale Financial Assets	Treasury Stock	Total
Balance, January 1, 20X8:	€ 20,000	€ 14,125	€ 14,097	€ 424,847	€ 0	€ 0	€ 0	€ 473,069
As reported								
Retrospective application of change in inventory methods (net of tax effect of \$4,000)				6,000				6,000
As adjusted	20,000	14,125	14,097	430,847	-	-	-	479,069
Net income (adjusted)				97,365				97,365
Cash dividends:								
Preferred				(20,000)				(20,000)
Common				(16,208)			(2,843)	(16,208)
Acquisition of treasury shares								(2,843)
Balance, December 31, 20X8	€ 20,000	€ 14,125	€ 14,097	€ 492,004	€ 0	€ 0	(€ 2,843)	€ 537,383
Net income				97,020				97,020
Cash dividends:								
Preferred				(15,000)				(15,000)
Common				(16,573)				(16,573)
Issuance of stock dividend		2,825	4,803	(7,628)				-
Issuance of common stock		8,729	14,782					23,511
Additional paid-in capital from stock options			9,000					-
Sale of treasury shares			23,156				2,843	9,000
Total comprehensive income for the year					(1,560)	4,470		25,999
Balance, December 31, 20X9	<u>€ 20,000</u>	<u>€ 25,679</u>	<u>€ 65,838</u>	<u>€ 549,823</u>	<u>(€ 1,560)</u>	<u>€ 4,470</u>	<u>€ 0</u>	<u>€ 664,250</u>

M&M Corporation
Statements of Cash Flows
For the Years Ended December 31, 20X9 and 20X8

	In thousands of euro	
	20X9	20X8
Cash flows from operating activities:		
Profit for the period	€ 97,020	€ 97,365
Adjustments to reconcile profit for the period to net cash flows from operating activities:		
Income tax expense recognized in profit	65,559	65,418
Interest expense recognized in profit	33,442	38,075
Depreciation and amortization	73,146	78,170
Goodwill impairment loss	6,896	-
Noncash stock compensation	9,000	-
(Gain) loss on trading securities	(6,500)	(210)
Gain from debt extinguishment	-	(20,000)
Loss from expropriation of assets	-	10,000
Loss on sale of net assets of discontinued segment	1,957	-
	<u>280,520</u>	<u>268,818</u>
Changes in operating assets and liabilities:		
(Increase) decrease in accounts receivable	(20,027)	2,546
(Increase) decrease in inventories	(54,068)	3,407
(Increase) decrease in prepaid assets	7,556	656
Increase (decrease) in accounts payable	(960)	(480)
Increase (decrease) in other accrued liabilities	736	(125)
Cash generated by operating activities	<u>213,757</u>	<u>274,822</u>
Interest paid	(28,356)	(35,588)
Income taxes paid	<u>(53,011)</u>	<u>(53,275)</u>
Net cash generated by operating activities	<u>132,390</u>	<u>185,959</u>
Cash flows from investing activities:		
Acquisition of land	(6,207)	-
Acquisition of buildings	(84,899)	(48,710)
Sale of trading securities		4,506
Disposal of discontinued segment	14,213	-
Tax benefit on disposal of discontinued segment	880	507
Acquisition of biological assets	<u>(30,000)</u>	<u>(30,000)</u>
Net cash flows from investing activities	<u>(106,013)</u>	<u>(73,697)</u>
Cash flows from financing activities:		
Extinguishment of long-term bonds	-	(80,000)
Payment on leases	(25,658)	(23,325)
Payment on short-term notes	(10,500)	(8,829)
Current borrowings on short-term notes	-	10,500
Sale of common stock	23,511	-
Acquisition of treasury stock		(2,843)
Sale of treasury stock	25,999	-
Cash dividends	<u>(30,480)</u>	<u>(36,533)</u>
Net cash flows from financing activities	<u>(17,128)</u>	<u>(141,030)</u>
Net increase (decrease) in cash and cash equivalents	9,249	(28,768)
Cash and cash equivalents, January 1	77,011	105,779
Cash and cash equivalents, December 31	<u>€ 86,260</u>	<u>€ 77,011</u>

Glossary

Acquiree – The business or businesses that the acquirer obtains control in a business combination.

Acquirer – The entity that obtains control of the acquiree.

Acquisition Method – The method required by SFAS 141R. Prior to SFAS 141, the purchase method was required.

Biological assets – A living plant or animal.

Business – An integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower costs or other economic benefits directly to investors or other owners, members or participants.

Cash – Cash on hand and demand deposits.

Cash Equivalents – 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.

Cash Generating Unit – A cash-generating unit is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

Contingency (IFRSs) – A contingency is a:

- Possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- Present obligation that arises from past events but is not recognized because:
 - It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - The amount of the obligation cannot be measured with sufficient reliability.

Contingency (U.S. GAAP) – A contingency as “an existing condition, situation, or set of circumstances involving uncertainty as to possible gain or loss to an enterprise that will ultimately be resolved when one or more future events occur or fail to occur.” An entity recognizes a contingent liability when:

- Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.
- The amount of loss can be reasonably estimated.

Contractual Contingency – Contingencies related to contracts.

Financial Asset – Any asset that is:

- Cash;
- An equity instrument of another entity;
- A contractual right to:
 - Receive cash or another financial asset from another entity; or
 - Exchange financial assets or financial liabilities with another entity under conditions that are potentially favorable to the entity; or
- A contract that will or may be settled in the entity's own equity instruments and is a:
 - Non-derivative for which the entity is or may be obliged to receive a variable number of the entity's own equity instruments; or
 - Derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Financial Liability – A financial liability is any liability that is a:

- Contractual obligation to:
 - Deliver cash or another financial asset to another entity; or
 - Exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity; or
- Contract that will or may be settled in the entity's own equity instruments and is a:
 - Non-derivative for which the entity is or may be obliged to deliver a variable number of the entity's own equity instruments; or
 - Derivative that will or may be settled other than by the exchange of a fixed amount of cash or another financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include instruments that are themselves contracts for the future receipt or delivery of the entity's own equity instruments.

Financing Activities – Activities that result in changes in the size and composition of the contributed equity and borrowings of the entity.

Goodwill – An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognized.

Grant Date – The date on which the entity and another party have an understanding of the terms and conditions of the share-based arrangement.

Investing Activities – The acquisition and disposal of long-term assets and other investments not included in cash equivalents.

Noncontractual Contingency – Contingencies other than contractual contingencies.

Noncontrolling Interest – The equity in a subsidiary not attributable, directly or indirectly, to a parent.

Not-for-profit Organization – An entity that possesses the following characteristics: (a) contributions of significant amounts of resources from resource providers who do not expect commensurate or proportional pecuniary return, (b) operating purposes other than to provide goods or services at a profit, and (c) absence of ownership interests like those of business enterprises.

Operating Activities – The principal revenue-producing activities of the entity and other activities that are not properly classified investing or financing activities.

Performance Commitment – A commitment under which performance by the counterparty to earn the equity instruments is probable because of sufficiently large disincentives for nonperformance.

Primary Beneficiary – A primary beneficiary is an enterprise that consolidates a variable interest entity under the provisions of FIN 46R.

Probable (IFRS) – An event is regarded as probable if the event is more likely than not to occur, i.e., the probability that the event will occur is greater than the probability that it will not.

Probable (U.S. GAAP) – The future event or events are likely to occur.

Provision – A provision is a liability of uncertain timing or amount. Under IAS 37, an entity recognizes a provision when an entity:

- Has a present obligation (legal or constructive) as a result of a past event;
- Will probably have outflow of resources embodying economic benefits to settle the obligation; and
- Can make a reliable estimate of the amount of the obligation.

Purchase Method – Under the purchase method, a business combination is deemed to be the acquisition of one entity by another. The acquisition cost is the fair value of the consideration given or the fair value of the net assets received, whichever is more clearly determinable.

The acquiring entity must allocate the total acquisition cost to the assets acquired and liabilities assumed. All identifiable assets acquired (all assets other than goodwill) are assigned a portion of the acquisition cost equal to their fair values at the date of acquisition. Any excess of the acquisition cost over the amounts assigned to identifiable assets and liabilities is recognized as goodwill.

Recoverable Amount – The recoverable amount of an asset or a cash-generating unit is the higher of its fair value less costs to sell and its value in use.

Reporting Unit – A reporting unit is the level of reporting at which goodwill is tested for impairment. It is an operating segment or one level below an operating segment, as that term is defined in SFAS 131.

Restructuring Costs – A program that is planned and controlled by management, and materially changes either the:

- Scope of a business undertaken by an entity; or
- Manner in which that business is conducted.

Value in Use – An entity estimates the value in use of an asset as the present value of the cash flows it expects to derive from the asset. The entity must include the following elements in the calculation of an asset's value in use:

- An estimate of the future cash flows the entity expects to derive from the asset;
- Expectations about possible variations in the amount or timing of those future cash flows;
- The time value of money, represented by the current market risk-free rate of interest;
- The price for bearing the uncertainty inherent in the asset; and
- Other factors, such as illiquidity, that market participants would reflect in pricing the future cash flows the entity expects to derive from the asset.

Variable Interest Entity – A variable interest entity is an entity subject to consolidation according to the provisions of FASB Interpretation No. 46 (revised December 2003).

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