1 INTRODUCTION TO INTERNATIONAL FINANCIAL REPORTING STANDARDS

The year 2005 marked the start of a new era in global business, and the fulfillment of a thirty-year effort to create the financial reporting rules for a worldwide capital market. For during that year’s financial reporting cycle, as many as 7,000 listed companies in the 25 European Union member states, plus many others in countries such as Russia, Australia, South Africa and New Zealand, were expected (in the EU, required) to produce annual financial statements in compliance with a single set of international rules—International Financial Reporting Standards (IFRS). Many others, while not publicly held and not currently required to comply with IFRS, will do so either immediately or over time, in order to conform to what is clearly becoming the new worldwide standard. Since there are about 15,000 SEC-registered companies in the USA that use US GAAP (plus countless nonpublicly held companies reporting under GAAP), the vast majority of the world’s large businesses will now be reporting under one or the other of these two comprehensive systems of accounting and financial reporting rules.

Encouraging this process, the standard setters have agreed to try to converge their measurement and recognition rules, so that differences between these two sets of requirements are already disappearing. In fact, the chairman of the US standard setter has suggested that by 2010 there would be no major differences left, and the SEC has speculated that the remaining differences might become so trivial that the currently required reconciliations required in Form 20-F filings by foreign registrants might be dispensed with entirely well before the end of the decade. However, there are undoubtedly many obstacles left to overcome, particularly as national securities regulators learn to live with the idea of using rules developed outside their jurisdiction by an autonomous panel of experts.
Origins and Early History of the IASB

Financial reporting in the developed world evolved from two broad models, whose objectives were somewhat different. The earliest systematized form of accounting regulation developed in continental Europe, starting in France in 1673. Here a requirement for an annual fair value balance sheet was introduced by the government as a means of protecting the economy from bankruptcies. This form of accounting at the initiative of the state to control economic actors was copied by other states and later incorporated in the 1807 Napoleonic Commercial Code. This method of regulating the economy expanded rapidly throughout continental Europe, partly through Napoleon’s efforts and partly through a willingness on the part of European regulators to borrow ideas from each other. This “code law” family of reporting practices was much developed by Germany after its 1870 unification, with the emphasis moving away from market values to historical cost and systematic depreciation. It was used later by governments as the basis of tax assessment when taxes on profits started to be introduced, mostly in the early twentieth century.

This model of accounting serves primarily as a means of moderating relationships between the individual company and the state. It serves for tax assessment, and to limit dividend payments, and it is also a means of protecting the running of the economy by sanctioning individual businesses that are not financially sound or were run imprudently. While the model has been adapted for stock market reporting and group (consolidated) structures, this is not its main focus.

The other model did not appear until the nineteenth century and arose as a consequence of the industrial revolution. Industrialization created the need for large concentrations of capital to undertake industrial projects (initially, canals and railways) and to spread risks between many investors. In this model the financial report provided a means of monitoring the activities of large businesses in order to inform their (nonmanagement) shareholders. Financial reporting for capital markets purposes developed initially in the UK, in a common-law environment where the state legislated as little as possible and left a large degree of interpretation to practice and for the sanction of the courts. This approach was rapidly adopted by the US as it, too, became industrialized. As the US developed the idea of groups of companies controlled from a single head office (towards the end of the nineteenth century), this philosophy of financial reporting started to become focused on consolidated accounts and the group, rather than the individual company. For different reasons neither the UK nor the US governments saw this reporting framework as appropriate for income tax purposes, and in this tradition, while the financial reports inform the assessment process, taxation retains a separate stream of law, which has had little influence on financial reporting.

The second model of financial reporting, generally regarded as the Anglo-Saxon financial reporting approach, can be characterized as focusing on the relationship between the business and the investor, and on the flow of information to the capital markets. Government still uses reporting as a means of regulating economic activity (e.g., the SEC’s mission is to protect the investor and ensure that the securities markets run efficiently), but the financial report is aimed at the investor, not the government.

Neither of the two above-described approaches to financial reporting is particularly useful in an agricultural economy, or to one that consists entirely of microbusinesses, in the opinion of many observers. Nonetheless, as countries have developed economically (or as they were colonized) they have adopted variants of one or the other of these two models.

IFRS are an example of the second, capital market-oriented, systems of financial reporting rules. The original international standard setter, the International Accounting Standards Committee (IASC), was formed in 1973, during a period of considerable change in accounting regulation. In the US the Financial Accounting Standards Board (FASB) had just
been created, in the UK the first national standard setter had recently been organized, the EU was working on the main plank of its own accounting harmonization plan (the Fourth Directive), and both the UN and the OECD were shortly to create their own accounting committees. The IASC was launched in the wake of the 1972 World Accounting Congress (a five-yearly get-together of the international profession) after an informal meeting between representatives of the British profession (Institute of Chartered Accountants in England and Wales—ICA EW) and the American profession (American Institute of Certified Public Accountants—AICPA).

A rapid set of negotiations resulted in the professional bodies of Canada, Australia, Mexico, Japan, France, Germany, the Netherlands, and New Zealand being invited to join with the US and UK to form the international body. Due to pressure (coupled with a financial subsidy) from the UK, the IASC was established in London, where its successor, the IASB, remains today.

The actual reasons for the IASC’s creation are unclear. A need for a common language of business was felt, to deal with a growing volume of international business, but other, more political motives abounded also. For example, some believe that the major motivation was that the British wanted to create an international standard setter to trump the regional initiatives within the EU, which leaned heavily to the Code model of reporting, in contrast to what was the norm in the UK and almost all English-speaking nations.

In the first phase of its existence, the IASC had mixed fortunes. Once the International Federation of Accountants (IFAC) was formed in 1977 (at the next World Congress of Accountants), the IASC had to fight off attempts to become a part of IFAC. It managed to resist, coming to a compromise where IASC remained independent but all IFAC members were automatically members of IASC, and IFAC was able to nominate the membership of the standard-setting Board.

Both the UN and OECD were active in international rule making in the 1970s but the IASC successfully persuaded them that they should leave recognition and measurement rules to the IASC. However, having established itself as the unique international rule maker, IASC had great difficulty in persuading anyone to use its rules. Although member professional bodies were theoretically committed to pushing for the use of IFRS at the national level, in practice few national bodies were influential in standard setting in their respective countries, and others (including the US and UK) preferred their national standards to whatever IASC might propose. In Europe, IFRS were used by some reporting entities in Italy and Switzerland, and national standard setters in some countries such as Malaysia began to use IFRS as an input to their national rules, while not necessarily adopting them as written by the IASC or giving explicit recognition to the fact that IFRS were being adopted in part as national GAAP.

IASC entered a new phase in 1987, which led directly to its 2001 reorganization, when the then-Secretary General, David Cairns, encouraged by the US SEC, negotiated an agreement with the International Organization of Securities Commissions (IOSCO). IOSCO was looking for a common international “passport” with which companies could be accepted for a secondary listing in the jurisdiction of any IOSCO member. The concept was that, whatever the listing rules in a company’s primary stock exchange, there would be a common minimum package which all stock exchanges would accept from foreign companies seeking a secondary listing. IOSCO was prepared to use IFRS as the financial reporting basis for this passport, provided that the international standards could be brought up to the level IOSCO stipulated. For the first time, the IASC would have a clear client and a clear role for its standards.

Historically, a major criticism of IFRS was that it essentially endorsed all accounting methods then in wide usage, effectively becoming a “lowest common denominator” set of
standards. The trend in national GAAP was to narrow the range of acceptable alternatives, although uniformity was not anticipated in the near term. The IOSCO agreement provoked frenetic activity to improve the existing standards by removing the many alternative treatments which were permitted under the standards. The IASC launched its comparability and improvements project to develop a “core set of standards” as demanded by IOSCO. These were complete by 1993, not without disagreements between members, but—to the great frustration of the IASC—were then not accepted by IOSCO. IASC leaders were unhappy, amongst other things, that IOSCO seemingly wanted to cherry-pick individual standards, rather than endorse the IASC’s process and thus all the standards created thereby.

Ultimately, the collaboration was relaunched in 1995, with IASC under new leadership, and this began a further frenetic period where existing standards were again reviewed and revised, and new standards were created to fill perceived gaps. This time the set of standards included, amongst others, IAS 39, on recognition and measurement of financial instruments, which had been accepted, at the very last moment and with great difficulty, as a compromise, purportedly interim standard.

At the same time, the IASC had established a committee to contemplate its future structure. In part, this was the result of pressure exerted by the US SEC and the US private sector standard setter, the FASB, which were seemingly concerned that IFRS were not being developed by “due process.” While there may have been other agendas by some of the parties (the FASB, for example, was opposed to IFRS at the time and hoped that US GAAP would instead be accepted by other nations), in fact the IFRS were in need of strengthening, particularly as to reducing the range of diverse but accepted alternatives for similar transactions and events.

If IASC was to be the standard setter endorsed by the world’s stock exchange regulators, it would need a structure that reflected that level of responsibility. The historical Anglo-Saxon standard-setting model—where professional accountants set the rules for themselves—had largely been abandoned in the twenty-five years since the IASC was formed, and standards were mostly being set by dedicated and independent national boards such as the FASB, and not by profession-dominated bodies like the AICPA. The choice, as restructuring became inevitable, was between a large, representative approach—much like the existing IASC structure, but where national standard setters sent representatives—or a small, professional body of experienced standard setters which worked independently.

The end of this phase of the international standard setting, and the resolution of these issues, came about within a short period in 2000. In May, IOSCO members voted at their annual meeting to endorse IASC standards, albeit subject to a number of reservations (see discussion later in this chapter). This was a considerable step forward for the IASC, which was quickly surpassed by an announcement in June 2000 that the European Commission intended to adopt IFRS as the requirement for primary listings in all member states. This planned full endorsement by the EU eclipsed the less than enthusiastic IOSCO announcement, and since then the EU has appeared to be the more influential body as far as gaining acceptance for IFRS is concerned.

In July 2000, IASC members voted to abandon the old structure based on professional bodies and adopt a new structure: beginning in 2001, standards would be set by a professional board, financed by voluntary contributions raised by a new oversight body.

The New Structure

The formal structure put in place in 2000 has the IASC Foundation, a Delaware corporation, as its keystone. The Trustees of the IASC Foundation have both the responsibility to raise the $15 million a year needed to finance standard setting, and the responsibility of appointing members to the International Accounting Standards Board (IASB), the
The Standards Advisory Council (SAC) meets with the IASB three times a year, generally for two days. The SAC consists of about 50 members, nominated in their personal (not organizational) capacity, but are usually supported by organizations that have an interest in international reporting. Members currently include analysts, corporate executives, auditors, standard setters, and stock exchange regulators. The members are supposed to serve as a channel for communication between the IASB and its wider group of constituents, to suggest topics for the IASB’s agenda, and to discuss IASB proposals.

The International Financial Reporting Interpretations Committee (IFRIC) is a committee comprised mostly of technical partners in audit firms but also includes preparers and users. It succeeds the Standards Interpretations Committee (SIC), which had been created by the IASC. SIC/IFRIC’s function is to answer technical queries from constituents about how to interpret IFRS—in effect, filling in the cracks between different rules. In recent times it has also proposed modifications to standards to the IASB, in response to perceived operational difficulties or need to improve consistency. IFRIC liaises with the US Emerging Issues Task Force and similar bodies liaison as standard setters, to try at preserve convergence at the level of interpretation. It is also establishing relations with stock exchange regulators, who may be involved in making decisions about the acceptability of accounting practices, which will have the effect of interpreting IFRS.

The liaison standard setters are national bodies from Australia, Canada, France, Germany, UK, USA, and Japan. Each of these bodies has a special relationship with a Board member, who normally maintains an office with the national standard setter and is responsible for liaison between the international body and the national body. This, together with the SAC, was the solution arrived at by the old IASC in an attempt to preserve some geographical representativeness. However, this has been somewhat overtaken by events: as far as the EU is concerned, its interaction with the IASB is through EFRAG (see below), which has no formal liaison member of the Board. The IASB Deputy Chairman has performed this function, but while France, Germany and the UK individually have liaison, EFRAG and the European Commission are, so far, outside this structure.

Furthermore, there are many national standard setters, particularly from developing countries, that have no seat on the SAC, and therefore have no direct link with the IASB, despite the fact that many of them seek to reflect IASB standards in their national standards.
At the October 2002 World Congress in Hong Kong, the IASB held an open meeting for national standard setters, which was met with enthusiasm. As a result, IASB began to provide time concurrent with formal liaison standard setters’ meetings for any other interested standard setters to attend. While this practice is not enshrined in either the Constitution or the IASB’s operating procedures, both are under review at the moment and changes may be in place for 2005.

Process of IFRS Standard Setting

The IASB has a formal due process which is set out in the Preface to IFRS, revised in 2001. As a minimum, a proposed standard should be exposed for comment, and these comments should be reviewed before issuance of a final standard, with debates open to the public. However, this formal process is rounded out in practice, with wider consultation taking place on an informal basis.

The IASB’s agenda is determined in various ways. Suggestions are made by the Trustees, the SAC, liaison standard setters, the international audit firms and others. These are debated by the Board and tentative conclusions are discussed with the various consultative bodies. The IASB also has a joint agenda committee with the FASB. Long-range projects are first put on the research agenda, which means that preliminary work is being done on collecting information about the problem and potential solutions. Projects can also arrive on the current agenda outside that route.

The agenda has been dominated in the years since 2001 by the need to round out the legacy standards, so that there would be a full range of standards for European companies moving to IFRS in 2005, as well as to carry out urgent modifications in the name of convergence (acquisition accounting and goodwill) and improvements to existing standards. These needs have largely been met as of mid-2004.

Once a project reaches the current agenda, the formal process is that the staff (a group of about 20 technical staff permanently employed by the IASB) drafts papers which are then discussed by the Board in open meetings. Following that debate, the staff rewrites the paper, or writes a new paper which is debated at a subsequent meeting. In theory there is an internal process where the staff proposes solutions, and the Board either accepts or rejects them. In practice the process is more involved: sometimes (especially for projects like financial instruments) specific Board members are allocated a special responsibility for the project, and they discuss the problems regularly with the relevant staff, helping to build the papers that come to the Board. Equally, Board members may write or speak directly to the staff outside of the formal meeting process to indicate concerns about one thing or another.

The process usually involves: (1) discussion of a paper outlining the principal issues; (2) preparation of an Exposure Draft that incorporates the tentative decisions taken by the Board—during which process many of these are redebated, sometimes several times; (3) publication of the Exposure Draft; (4) analysis of comments received on the Exposure Draft; (5) debate and issue of the final standard, accompanied by application guidance and a document setting out the Basis for Conclusions (the reasons why the Board rejected some solutions and preferred others). Final ballots on the Exposure Draft and the final standard are carried out in secret, but otherwise the process is quite open, with outsiders able to consult project summaries on the IASB Web site and attend Board meetings if they wish. Of course, the informal exchanges between staff and Board on a day-to-day basis are not visible to the public, nor are the meetings where the Board takes strategic and administrative decisions.

The basic due process can be modified in different circumstances. If the project is controversial or particularly difficult, the Board may issue a discussion paper before proceeding to Exposure Draft stage. It reissued a discussion paper on stock options before proceeding to
IFRS 2, Share-Based Payment. It is also doing this with its reporting performance project and its project on standards for small and medium-sized enterprises. Such a discussion paper may just set out what the staff considers to be the issues, or it may do that as well as indicate the Board’s preliminary views.

The Board may also hold some form of public consultation during the process. When revising IAS 39, Financial Instruments: Recognition and Measurement in 2003, it held round table discussions. Respondents to the Exposure Draft were invited to participate in small groups with Board members where they could put forward their views and engage in debate.

Apart from these formal consultative processes, the Board also carries out field trials of some standards (as it recently did on performance reporting and insurance), where volunteer preparers apply proposed new standards. The international audit firms receive Board papers as a result of their membership on IFRIC and are also invited to comment informally at various stages of standard development.

Constraints

The debate within the Board demonstrates the existence of certain pervasive constraints that will influence the decisions taken by the Board. A prime concern is convergence. In October 2002 the IASB signed an agreement with the FASB (the Norwalk Agreement) stating that the two boards would seek to remove differences and converge on high-quality standards. This agreement set in motion short-term adjustments and both standard setters have since issued Exposure Drafts changing their rules to converge with the other on certain issues. It also involves long-term development of joint projects (business combinations, performance reporting, revenue recognition, etc.).

This desire for convergence is driven by the perception that international investment is made more risky by the use of multiple reporting frameworks, and that the global market needs a single global reporting base—but also specifically by the knowledge that European companies wish to be listed in the US, and have to provide reconciliations of their equity and earnings to US GAAP when they do this (foreign companies registered with the SEC have to prepare the annual filing on Form 20-F which, if the entity does not prepare reports under US GAAP, requires a reconciliation between the entity’s IFRS or national GAAP and US GAAP for earnings and equity. This reconciliation is costly to prepare and leads to companies publishing in effect two different operating results for the year, which is not always understood or appreciated by the market). If IFRS were substantially the same as US GAAP, the Form 20-F reconciliations hopefully would fade away (and the SEC has confirmed this is the likely outcome), so for European companies, convergence with US GAAP is an important issue.

A major concern for financial reporting is that of consistency, but this is a complex matter, since the Board has something of a hierarchy of consistency. As a paramount consideration, the Board would want a new standard to be consistent with its Conceptual Framework (discussed below). Thereafter, there may be a conflict between being consistent with US GAAP and being consistent with existing IAS/IFRS. However, there is little or no desire to maintain consistency with standards marked for extinction or major revision. For example, IASB believes that a number of extant standards are inconsistent with the Framework and need to be changed (e.g., IAS 20 on government grants), or are ineffective or obsolete (e.g., IAS 17 on leases), so there is little purpose in seeking to make a new standard consistent with them. Equally, since it aims to converge with US GAAP, it seems illogical to adopt a solution that is inconsistent with US GAAP, which will then have to be reconsidered as part of the convergence program.
Those members of the Board who have worked in North America are concerned that standards avoid creating abuse opportunities. Experience has sadly shown that there often will be attempts by preparers to engineer around accounting standards in order to be able to achieve the earnings or balance sheet amounts desired. This concern is sometimes manifested as a desire to avoid allowing exceptions. There is a justifiable perception that many standards become very complicated because they contain many exceptions to a simple basic rule.

IASB also manifests some concerns about the practicality of the solutions it mandates. While preparers might think that it is not sympathetic enough in this regard, it actually has limited the extent to which it requires restatements of previous years’ reported results when the rules change, particularly in IFRS 1, First-Time Adoption. The Framework does include a cost/benefit constraint—that the costs of the financial reporting should not be greater than the benefits to be gained from the information—which is often mentioned in debate, although IASB considers that preparers are not the best ones to measure the benefits of disclosure.

There is also a procedural constraint that the Board has to manage, which is the relationship between the Exposure Draft and the final standard. IASB’s due process requires that there should be nothing introduced in the final standard that was not exposed at the Exposure Draft stage, otherwise there would have to be reexposure of the material. This means that where there are several solutions possible, or a line can be drawn in several places, IASB may tend towards the most extreme position in the Exposure Draft, so as not to narrow its choices when redebating in the light of constituents’ comments.

Conceptual Framework for Financial Reporting

The IASB inherited the IASC’s Framework for the Preparation and Presentation of Financial Statements (the Framework). Like the other current conceptual frameworks among Anglo-Saxon standard setters, this derives from the US conceptual framework, or at least those parts of it completed in the 1970s. The Framework states that “the objective of financial statements is to provide information about the financial position, performance and changes in financial position of an enterprise that is useful to a wide range of users in making economic decisions.” The information needs of investors are deemed to be of paramount concern, but if financial statements meet their needs, other users’ needs would generally also be satisfied.

The Framework holds that users need to evaluate the ability of the enterprise to generate cash and the timing and certainty of its generation. The financial position is affected by the economic resources controlled by the entity, its financial structure, its liquidity and solvency, and its capacity to adapt to changes in the environment in which it operates.

The qualitative characteristics of financial statements are understandability, relevance, reliability and comparability. Reliability comprises representational faithfulness, substance over form, completeness, neutrality and prudence. It suggests that these are subject to a cost/benefit constraint, and that in practice there will often be a trade-off between characteristics. The Framework does not specifically include a “true and fair” requirement, but says that application of the specified qualitative characteristics should result in statements that present fairly or are true and fair (but note that IAS 1, Presentation of Financial Statement, does refer to the true and fair requirement).

Of great importance are the definitions of assets and liabilities. According to IASB, “an asset is a resource controlled by the enterprise as a result of past events and from which future economic benefits are expected to flow to the enterprise.” A liability is a “present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying future benefits.” Equity is simply
a residual arrived at by deducting the liabilities from assets. Neither asset nor liability are recognized in the financial statements unless they have a cost or value that can be measured reliably—which, as the Framework acknowledges, means that some assets and liabilities may remain unrecognized.

The asset and liability definitions have, in the past, not been central to financial reporting standards, many of which were instead guided by a “performance” view of the financial statements. For example, IAS 20 on government grants was suspended in 2004, in part because it allows government grants to be treated as a deferred credit and amortized to earnings, while a deferred credit does not meet the Framework definition of a liability. Similarly, IFRS 3 requires that where negative goodwill is identified in a business combination, this should be released to the income statement immediately—IAS 22 treated it as a deferred credit, which does not qualify as a liability.

Both FASB and IASB now intend to analyze solutions to reporting issues in terms of whether they cause any changes in assets or liabilities. The revenue recognition project which both are pursuing is an example of this. This project has tentatively embraced the view that where an entity receives an order and has a legally enforceable contract to supply goods or services, the entity has both an asset (the right to receive future revenue) and a liability (the obligation to fulfill the order) and it follows that, depending upon the measurement of the asset and the liability, some earnings could be recognized at that point. This would be a sharp departure from existing GAAP, under which executory contracts are almost never formally recognized, and never create earnings.

The IASB Framework is relatively silent on measurement issues. The three paragraphs that address this matter merely mention that several different measurement bases are available and that historical cost is the most common. Revaluation of tangible fixed assets is, for example, perfectly acceptable under IFRS for the moment. In practice IFRS have a mixed attribute model, based mainly in historical cost, but using value in use (the present value of expected future cash flows from the use of the asset within the entity) for impairment and fair value (market value) for some financial instruments, biological assets, business combinations and investment properties.

Hierarchy of Standards

The Framework is used by IASB members and staff in their debate, and they expect that those commenting on Exposure Drafts will articulate their arguments in terms of the Framework. However, the Framework is not intended normally to be used directly by preparers and auditors in determining their accounting methods. In its 2003 revision of IAS 8, IASB introduced a hierarchy of accounting rules that should be followed by preparers in seeking solutions to accounting problems. This hierarchy says that the most authoritative guidance is IFRS, and the preparer should seek guidance as follows:

1. IAS/IFRS and SIC/IFRIC Interpretations, when these specifically apply to a transaction or condition.
2. In the absence of such a directly applicable standard, judgement is to be used to develop and apply an accounting policy that is relevant to the economic decision-making needs of the users, and is reliable in that the financial statements: represent faithfully the financial position, financial performance and cash flows of the reporting entity; reflect the economic substance of transactions, events and conditions, rather than merely the legal forms thereof; are neutral; are prudent; and are complete in all material respects.
3. If this is not possible, the preparer should then look to recent pronouncements of other standard setters which use a similar conceptual framework to develop its stan-
dards, as well as other accounting literature and industry practices that do not conflict with higher level guidance.

4. Only if that also fails should the preparer look to the IASB Framework directly.

In effect, therefore, if IFRS do not cover a subject, the preparer should look to national GAAP, and the most obvious choice is US GAAP, partly because that is the most complete set of standards, and partly because in the global capital market, US GAAP is the alternative best understood (and use of US GAAP removes reconciliation items on the Form 20-F for foreign SEC registrants). In any event, given the professed intention of IFRS and US GAAP to converge, it would make little sense to seek guidance in any other set of standards, unless US GAAP were also silent on the matter needing clarification.

The IASB and the US

Although IASC and FASB were created almost contemporaneously, FASB largely ignored IASC until the 1990s. It was only at the beginning of the 1990s that FASB started to become interested in IASC. This was the period when IASC was starting to work with IOSCO, a body in which the SEC has always had a powerful voice. In effect, both the SEC and FASB were starting to look to the international, and IASC was also starting to take initiatives to encourage standard setters to meet together occasionally to debate technical issues of common interest.

IOSCO’s efforts to create a single passport for secondary listings, and IASC’s role as its standard setter, while intended to operate worldwide, would have the greatest significance for foreign issuers in terms of the US market. If the SEC were to accept IFRS in place of US GAAP, there would be no need for a Form 20-F reconciliation, and access to the US markets would be greatly facilitated. The SEC has therefore been a key actor in the later evolution of IASC. It encouraged IASC to build a relationship with IOSCO in 1987. It also observed that there were too many options under IAS. When IASC restarted its IOSCO work in 1995, the SEC issued a statement (April 1996) saying that, to be acceptable, IFRS must satisfy three criteria.

1. They must include a core set of standards that constituted a comprehensive basis of accounting;
2. The standards must be high quality, and enable investors to analyze performance meaningfully both across time periods and between companies; and
3. The standards must be rigorously interpreted and applied, otherwise comparability and transparency would not be achieved.

The plan with IOSCO involved IASC completion of its core set of standards, then handing these over to IOSCO, which in turn would ask its members to evaluate them, and finally IOSCO would issue its verdict. It was in this context the SEC issued a “concept release” in 2000, in which it asked for comments on the acceptability of the core set of standards, but crucially on whether there was a sufficient compliance and enforcement mechanism to ensure that standards were consistently and rigorously applied by preparers, that auditors would ensure this and stock exchange regulators would check compliance.

This latter element is something which is beyond the control of the IASC and IASB. The Standards Interpretations Committee was formed to help ensure uniform interpretation, and IFRIC has taken a number of initiatives to build liaison channels with stock exchange regulators and national interpretations bodies, but the rest is in the hands of the auditors, the audit oversight bodies, and the stock exchange oversight bodies. The SEC concepts release resulted in many comment letters, which can be viewed on the SEC Web site (www.sec.gov), but in the five years since its issue, the SEC has taken no definitive position.
The SEC’s stance seems to be that it genuinely wants to see IFRS used by foreign registrants, but that it prefers convergence (so that no reconciliation is necessary) to acceptance without reconciliation of the IFRS as they were in 2000. The SEC in its public pronouncements regularly supports convergence. The SEC welcomed publicly the changes to US standards proposed by the FASB in December 2003, made to converge with IFRS.

Relations between FASB and IASB have grown ever warmer. The FASB joined the IASB for informal meetings in the early 1990s, and this led to the creation of the G4+1 group of Anglo-Saxon standard setters (US, UK, Canada, Australia and New Zealand, with the IASC as an observer) in which FASB was an active participant. IASB and FASB signed the Norwalk Agreement in October 2002, which set out a program of convergence, and their staffs now work together on a number of projects, including business combinations and revenue recognition. Video links are used to enable staff to observe and participate in board meetings. The two boards have a joint agenda committee whose aim is to harmonize the timing with which the boards discuss the same subjects. The boards are also committed to meeting twice a year in joint session.

However, this rosy picture of cooperation is not the full one. FASB works in a specific national legal framework, while IASB does not. Equally, both have what they term “inherited” GAAP (i.e., differences in approach that have a long history and are not easily removed). FASB also has a tradition of issuing very detailed, prescriptive (“rules-based”) standards that give bright line audit guidance, which are intended to make compliance control easier and remove uncertainties. In the post-Enron world, after it became clear that such prescriptive rules had been abused, there was a flurry of interest in standards that supposedly express an objective and then explain how to reach it (“principles-based” standards), without attempting to prescribe responses to every conceivable fact pattern. However, as the SEC study into principles-based standards observed, use of principles alone, without detailed guidance, reduces comparability. The litigation environment in the US also makes companies and auditors reluctant to step into areas where judgments have to be taken in uncertain conditions.

The IASB and Europe

While France, Germany, the Netherlands and the UK were founding members of IASC and have remained heavily involved, the European Commission as such has generally had a difficult relationship with the international standard setter. It did not participate in any way until 1990, when it finally became an observer at Board meetings. It had had its own regional program of harmonization since the 1960s and in effect only officially abandoned this in 1995, when, in a policy paper, it recommended to member states that they seek to align their rules for consolidated financial statements on IAS. However, the Commission then went on to give IASB a great boost when it announced in June 2000 that it wanted to require all listed companies throughout the EU to use IFRS beginning in 2005 as part of its initiative to build a single European financial market. This intention was made concrete with the approval of the IFRS Regulation in June 2002 by the European Council of Ministers (the supreme EU decision-making authority).

The EU decision was all the more surprising in that, to be effective in legal terms, IFRS have to become enshrined in EU statute law, creating a situation where the EU is in effect rubber-stamping laws created by a small, self-appointed, private sector body. This is a delicate situation, which has proved within a very short time that it contains the seeds of unending disagreements: politicians are being asked in effect to endorse something over which they have no control, and are being lobbied by corporate interests who have failed to influence IASB directly to achieve their objectives. The EU endorsement of IFRS turns out to
have the cost of exposing IASB to political pressures in the same way that FASB has at times been the focus of congressional manipulations in the US.

The EU created an elaborate machinery to mediate its relations with IASB. It preferred to work with another private sector body, created for the purpose, as the formal conduit for EU inputs to IASB. The European Financial Reporting Advisory Group (EFRAG) was formed in 2001 by a collection of European representative organizations (for details see www.efrag.org), including the European Accounting Federation (FEE) and European employer organization (UNICE). This in turn formed a small Technical Expert Group (TEG) which does the detailed work on IASB proposals. EFRAG consults widely within the EU, and particularly with national standard setters and the European Commission to canvass views on IASB proposals, and provides inputs to IASB. It responds formally to all discussion papers and Exposure Drafts.

At a second stage, when a final standard is issued, EFRAG is asked by the Commission to provide a report on the standard. This report should state whether the standard has the required qualities and is in conformity with the European company law directives. The European Commission then asks a new committee, the Accounting Regulation Committee (ARC), whether it wishes to endorse the standard. ARC consists of permanent representatives of the EU member state governments. It should normally only fail to endorse IFRS if it believes they are not in conformity with the overall framework of EU law; it should not take a strategic or policy view. However, the European Parliament also has the right to comment, if it wishes. If ARC fails to endorse a standard, the European Commission may still ask the Council of Ministers to override that decision.

Experience has shown that the system suffers from a number of problems. First, although EFRAG is intended to enhance EU inputs to IASB, it may in fact isolate people from IASB, or at least increase the costs of making representations. For example, when IASB revealed its intentions of issuing a standard on stock options, it received nearly a hundred comment letters from US companies (who report under US GAAP, not IFRS), but only one EFRAG, which represents about 90% of IASB’s constituents. It is easy to feel in this context that EFRAG is seen at IASB as a single respondent, so people who have made the effort to work through EFRAG feel under-represented. In addition, EFRAG is bound to present a distillation of views, so it is already filtering respondents’ views before they even reach IASB. The only recourse is for respondents to make representations not only to EFRAG but also directly to IASB.

However, resistance to the financial instruments standards, IAS 32 and IAS 39, has put the system under specific strain. These standards were already in existence when the European Commission announced its decision to adopt IFRS for European listed companies, and were exhaustively debated—but they have since become once more a political football. The first task of EFRAG and ARC was to endorse the existing standards of IASB. They did this—but excluded IAS 32 and 39 on the grounds that they were being extensively revised as part of IASB’s then-ongoing Improvements Project.

During the exposure period of the improvements proposals—which exceptionally included round table meetings with constituents—the European Banking Federation, under particular pressure from French banks, lobbied IASB to modify the standard to permit macrohedging. The IASB agreed to do this, even though that meant the issuance of a new Exposure Draft and a further amendment to IAS 39 (which was finally issued in March 2004). The bankers did not like the terms of the amendment, and while it was still under discussion, they appealed to the French president and persuaded him to intervene. He wrote to the European Commission in July 2003, saying that the financial instruments standards were likely to make banks’ figures volatile, would destabilize the European economy, and
should not be approved. He also said that the Commission did not have a sufficient input to the standard setting process.

This manipulation of IAS 39 was further compounded when the European Central Bank complained in February 2004 that the “fair value option,” introduced to IAS 39 as an improvement in final form in December 2003, could be used by banks to manipulate their prudential ratios, and asked IASB to limit the circumstances in which the option could be used. IASB agreed to do this, although again this meant issuing an Exposure Draft and a further amendment to IAS 39 which was not finalized until mid-2005. IASB, when it debated the issue, took a pragmatic line that no compromise of principle was involved, and that the principal bank regulator of the Board’s largest constituent by far should be accommodated. The fact that the European Central Bank had not raised these issues at the original Exposure Draft stage was not discussed, nor was the legitimacy of a constituent deciding unilaterally it wanted to change a rule that had just been approved. The Accounting Standards Board of Japan lodged a formal protest and many other constituents have not been delighted.

The ARC has not yet approved IAS 32 and IAS 39, and may well not do so before 2005, given the European Central Bank amendment. Clearly the EU’s involvement with IFRS is proving to be a mixed blessing for IASB, both exposing it to political pressures that are properly an issue for the Commission, not IASB, and putting its due process under stress. Some commentators consider that the EU might abandon IFRS, but this is not a realistic possibility, given that the EU has already tried and rejected the regional standard setting route. What is more probable is that we are enduring a period of adjustment, with both regulators and lobbyists uncertain as to how exactly the system works, testing its limits, but with some modus vivendi evolving over time. However, it is severe distraction for IASB that financial instruments, arguably the controversy of the 1990s, is still causing trouble, when it has on its agenda more radical ideas in the areas of revenue recognition, performance reporting and insurance contracts.

The Future Agenda for IFRS

IASB’s future program has already been influenced by poor reception of its ideas in the area of reporting comprehensive income. Field tests of its proposals in 2003 have resulted in a proposal now to align this project more closely with that of FASB and split into two subprojects. The shorter-term objective will be to agree to a basic standard format with FASB, including some display of other comprehensive income (FASB) or recognized income and expenditure (IASB), which puts earnings together with valuation changes that presently flow directly to equity. An Exposure Draft is still possible in 2005. The longer-term objective will be to refine the definitions used within the income statement and report fair value and other subsequent measurement changes in a more systematic fashion. The longer-term project will probably be the subject of a discussion paper as its next step.

The FASB is also involved in a revenue recognition project. This project is trying to revisit revenue recognition through an analysis of assets and liabilities (mentioned above) instead of the existing approach which focuses on completed transactions and realized revenue. Such an approach has major implications for the timing of earnings recognition—it would potentially lead to recognition in stages throughout the transaction cycle. It is unlikely that this project will lead to short-term changes, given the fundamental nature of the issues involved.

Linked to these projects, which are revisions and extensions of the conceptual framework, is a joint project with the Canadian Accounting Standards Board on initial measurement and impairment, and a catch-up project with FASB on liabilities and equity.
IASB is continuing its revisions of its business combinations standards in coordination with FASB. Both Boards are nearing completion of Phase II of their projects. IASB has tentatively agreed that where there are minority interests, these should be included in group equity and that goodwill should be calculated for 100% of the shareholders, not just the majority holding. It is still working on the definitions of contingent assets and liabilities acquired in a combination. IASB is also working on the criteria for consolidation (IAS 27) which it hopes to develop to deal more effectively with issues such as latent control and special-purpose entities. This may also turn into a joint project with FASB.

IASB is currently working on its own in the area of SME accounting (tailored standards for small and medium-sized entities), but this has now been taken up as well by the US standard setter and accounting profession. Broadly, the intention of this project (which was the subject of a Discussion Paper in 2004) is to produce a single accounting standard for SME which consists of simplified versions of the existing IFRS, analogous to what was done in the UK. IASB was initially reluctant to involve itself in this area, but was persuaded by a number of institutions, including the UN and the European Commission, that this was an urgent need. The crucial issue of what is an SME is couched in conceptual terms, as being an entity in which there is no public interest, but precise size terms are left to individual jurisdictions to determine. The definition excludes entities with listed equity or debt as well as those that which are economically significant.

The SME standard will likely be based on the “black letter paragraphs” of IFRS, with additional material as necessary. Where a preparer does not find the treatment needed, the entity should then refer to the substantive IFRS, although this does not then imply an obligation to comply with all the IFRS. The entity will be required to describe itself as reporting in accordance with the SME standard, and not as reporting in accordance with IFRS. The proposal is very similar to that of the UN’s expert group, which provided a guideline to its member states on differential reporting and an abbreviated form of IFRS in 2001.

While IFRS 4, issued in March 2004, provides a first standard on accounting for insurance contracts, this is only an interim standard issued to meet the needs of 2005 adopters, and it permits the retention of many existing national practices. IASB is committed to a full standard, which it had hoped to have in place by 2007, although this now seems unlikely. The project should now enter full development. Analysis thus far, based on an asset and liability approach, would potentially allow recognition of some gain on the signing of a long-term contract. This will undoubtedly cause insurance regulators some concerns. IASB is also using fair value as a working measurement assumption, which has aroused opposition from insurers, many of whom have long used an approach which smoothed earnings over long periods and ignored the current market values of insurance assets and liabilities. They claim that fair value will introduce volatility, which is likely true: IASB members have observed that the volatility is in the marketplace, and that the insurers’ accounts just do not reflect economic reality.

A project addressing IAS 30 disclosure requirements came to fruition in mid-2005 with the issuance of IFRS 7, covered in this book. It eliminates IAS 30 disclosures and merges them with those formerly in IAS 39, all of which are now incorporated into the new standard.

In mid-2005 IASB issued an Exposure Draft of an amendment to IAS 37. This evolved as part of the ongoing efforts to converge IFRS with US GAAP. In particular, it is responsive to the differences between IAS 37 (on provisions) and FAS 146, addressing certain disposal and exit activities and the costs properly accrued in connection with them. FAS 146 was promulgated, in part, to curtail the abuses commonly called providing “cookie jar reserves” during periods of corporate downsizing, when generous estimates were often made of future related costs, which in some instances served to absorb costs properly chargeable to future periods. In other cases, excess reserves (provisions) would later be released into in-
come, thereby overstating operating results of the later periods. FAS 146 applies strict criteria so that reserves that do not meet the definition of liabilities cannot be recorded. The proposal also will hew more closely to US GAAP’s approach to guarantees, which distinguish between the unconditional element—the promise to provide a service for some defined duration of time—and the conditional element, which is contingent on the future events, such as terminations, occurring.

If adopted, the amended IAS 37 would eliminate the terms contingent liability and contingent asset, and would restrict the meaning of constructive obligations so that these would be recognized as liabilities only if the reporting entity’s actions result in other parties having a valid expectation on which they can reasonably rely that the entity will perform. Furthermore, the probability criterion would be deleted, so that only if a liability is not subject to reasonable measurement would it be justifiable to not record it. Certain changes are also made to IAS 19 by this draft (see discussion in Chapter 12).

IASB also intends to replace IAS 20, with an Exposure Draft presently promised for late 2005. (See discussion in Chapter 26.)

Other current IASB projects include: business combinations (application of purchase accounting method—Exposure Draft issued mid-2005); business combinations (accounting for noncontrolling interests—Exposure Draft issued mid-2005); conceptual framework (discussion paper due in mid-2006, in joint project with FASB); consolidation of special-purpose entities; emission rights (Exposure Draft to replace withdrawn IFRIC 3 expected mid-2006); insurance contracts (phase II); and performance reporting (new standard for presentation of information on the face of the financial statements).

Europe 2005 Update

The IASB’s long effort to gain acceptance for IFRS began to bear fruit several years ago, when the EU abandoned a nascent quest to develop Euro-GAAP, and when IOSCO endorsed, with some qualifications, the “core set of standards” following major revisions to most of the then-extant IFRS. A significant impediment remains, however, as the US Securities and Exchange Commission still refuses to permit filings of financial statements prepared on the basis of IFRS without reconciliation of major items to US GAAP. However, the EU’s decision to require IFRS-based filings will provide a further impetus to acceptance—as will the IASB-FASB agreement to work toward full convergence of the standards.

Beginning January 1, 2005, all European Union (EU) companies having securities listed on an EU exchange must prepare consolidated (group) accounts in conformity with IFRS. It is estimated that this requirement will affect approximately 7,000 companies, of which some 3,000 are in the United Kingdom. By 2004, some 200 to 300 EU companies had already begun to report on an IFRS basis. In all or almost all instances, comparative financial statements will be required, meaning that restatement of 2004 financials will also be necessary in the first year’s (2005) presentations. However, by early 2005 the vast majority of companies affected by this requirement had not communicated the likely impacts of the change in basis of accounting to the stockholders, analysts or other constituents, and a surprisingly large fraction of analysts remained uneducated about IFRS.

In addition, it is likely that, within a reasonable period of time, all the EU states will permit IFRS in the consolidated accounts of nonlisted companies, although this permission, in some states, might not extend to certain types of companies such as small enterprises or charities. Moreover, most of the EU states will permit IFRS in the annual (i.e., not consolidated) accounts of all companies, again subject to some exceptions. In addition, some EU states have already begun to converge their national accounting rules with IFRS.
Privately held EU companies may also choose to utilize IFRS for many sound reasons (e.g., for comparability purposes), in anticipation of eventual convergence of national standards with IFRS, and at the specific request of stakeholders such as the entities’ credit and investment constituencies.

The remaining impediment to full IFRS conformity among the affected EU companies pertains to the financial instruments standard, IAS 39, which has proved to be extraordinarily controversial, at least among some reporting entities, particularly financial institutions in some, but not all, European countries. Originally, as noted above, all IAS/IFRS standards were endorsed, except IAS 32 and IAS 39, as to which endorsement was postponed, nominally because of expected further amendments coming from IASB, but actually due to the philosophical or political dispute over use of fair value accounting for financial instruments and hedging provisions. The single most important of the concerns pertained to accounting for “core deposits” of banks, which drew objections from five of the six dissenting votes on the EFRAG (European Financial Reporting Advisory Group) Technical Expert Group (TEG). In fact, the dissents were a majority of the eleven-member TEG, but since it takes a two-thirds vote to refuse endorsement, the tepid support would be sufficient.

Notwithstanding that IASB had promised a “stable platform” of rules (i.e., no changes or new standards to be issued during the massive transition to IFRS in Europe, so that preparers could be spared the frustration of a moving target as they attempted to prepare, usually, January 1, 2004 restated balance sheets and 2004 and 2005 financial statements under IFRS), the controversy over IAS 39 resulted in a number of amendments being made in 2005, mostly in order to mollify EU member states. Thus, IAS 39 was (separately) amended to deal with macroadjusting, cash flow hedges of forecast intragroup transactions, the “fair value option,” and financial guarantee contracts. (These changes are all addressed in this book.)

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Impact of IFRS Adoption by EU Companies

The effect of the change to IFRS will vary from country to country and from company to company. National GAAP of many European countries were developed for tax and other regulatory purposes, so principles differ from state to state. The Web pages of many EU accounting firms currently highlight the complexity and potential confusion involved in transitioning to IFRS.

Complexity means cost. One survey of 1,000 European companies indicates that the average compliance cost across UK companies will be about £360,000. This figure rises to £446,000 for a top-500 company; £625,000 for companies with a market capitalization value between £1bn-£2bn; and over £1m for companies valued at more than £2bn.

Implementation, however, is not the only difficulty, and possibly not even the most significant one. Changes in principles can mean significant changes in profit and loss statements or balance sheets. In a 2002 survey of EU companies, two-thirds of respondents indicated that the adoption of IFRS would have a medium to high impact on their businesses.

One of the most important effects of the now-occurring change to IFRS will reverberate throughout companies’ legal relationships. Obviously, companies must make appropriate
disclosure to their stakeholders in order to properly explain the changes and their impact. Additionally, accountants and lawyers will also have to review the significantly expanded footnote disclosures required by IFRS in financial statements.

In addition to appropriate stakeholder disclosure, companies must re-examine legal relationships which are keyed to accounting reports. Changed accounting principles can undermine carefully crafted financial covenants in shareholder agreements, financing contracts and other transactional documents.

Drafters must examine the use of “material adverse change” triggers in the context of businesses whose earnings may be subject to accounting volatility. Debt, equity and lease financing arrangements may require restructuring due to unanticipated changes in reported results arising from the use of IFRS.

For example, IFRS may require a reclassification of certain financial instruments previously shown as equity on a company’s balance sheet into their equity and debt components. Additionally, IFRS permits companies to adjust the carrying values of investment property (real estate) to fair market values with any gains being reflected in the income statement.

Executives may be concerned about compensation systems tied to earnings increases between measurement dates when earnings can be so volatile, or they may simply be concerned that compensation arrangements are keyed to results which are no longer realistic.

Few companies want to entertain dated or “frozen” GAAP for document purposes because of the costs involved in maintaining two separate systems of accounting. As a result, companies, their lawyers and accountants will have to re-examine agreements in light of the anticipated effect of IFRS on companies’ financial statements.
APPENDIX A
CURRENT INTERNATIONAL FINANCIAL REPORTING STANDARDS
(IAS/IFRS) AND INTERPRETATIONS (SIC/IFRIC)

(R) = Standard is revised or newly issued in 2004 or 2005

IAS 1  Presentation of Financial Statements (R)
IAS 2  Inventories
IAS 7  Cash Flow Statements
IAS 8  Accounting Policies, Changes in Accounting Estimates and Errors
IAS 10  Events After the Balance Sheet Date
IAS 11  Construction Contracts
IAS 12  Accounting for Taxes on Income
IAS 14  Reporting Financial Information by Segment
IAS 16  Property, Plant, and Equipment
IAS 17  Accounting for Leases
IAS 18  Revenue
IAS 19  Employee Benefits (R)
IAS 20  Accounting for Government Grants and Disclosure of Government Assistance
IAS 21  The Effects of Changes in Foreign Exchange Rates
IAS 23  Borrowing Costs
IAS 24  Related-Party Disclosures
IAS 26  Accounting and Reporting by Retirement Benefit Plans
IAS 27  Consolidated and Separate Financial Statements (R)
IAS 28  Accounting for Investments in Associates
IAS 29  Financial Reporting in Hyperinflationary Economies
IAS 30  Disclosures in the Financial Statements of Banks and Similar Financial Institutions (Superseded by IFRS 7 beginning in 2007)
IAS 31  Financial Reporting of Interests in Joint Ventures
IAS 32  Financial Instruments: Disclosures and Presentation (R)
IAS 33  Earnings Per Share
IAS 34  Interim Financial Reporting
IAS 36  Impairments of Assets (R)
IAS 37  Provisions, Contingent Liabilities, and Contingent Assets
IAS 38  Intangible Assets (R)
IAS 39  Financial Instruments: Recognition and Measurement (R)
IAS 40  Investment Property (R)
IAS 41  Agriculture
IFRS 1  First-Time Adoption of IFRS (R)
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<td>Jointly Controlled Entities—Nonmonetary Contributions by Venturers (IAS 31)</td>
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<td>Rights to Interests Arising from Decommissioning, Restoration and Environmental Rehabilitation Funds (IAS 8, IAS 27, IAS 28, IAS 31, IAS 37, IAS 39, SIC 12) (R)</td>
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<td>IFRIC 6</td>
<td>Liabilities Arising from Participating in a Specific Market—Waste Electrical and Electronic Equipment</td>
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APPENDIX B

CASE STUDY ILLUSTRATING POSSIBLE SUPPLEMENTAL TREATMENTS UNDER THE IOSCO RECOMMENDATIONS

The completion of a “core set of standards,” as agreed by IOSCO, was a major achievement, and IASC quite naturally expected that, having performed on its side of the bargain, IOSCO would likewise deliver on its explicit and implicit commitments. After almost four years, IOSCO’s technical committee gave a qualified endorsement in May 2000.

IOSCO’s endorsement came with certain strings attached in the form of “supplemental treatments.” As explained by IOSCO’s Presidents’ Committee resolution, these supplemental treatments are as follows:

- **Reconciliation**—Requiring reconciliation of certain items to show the effect of applying a different accounting method, in contrast with the method applied under IASC standards;
- **Disclosure**—Requiring additional disclosures, either in the presentation of the financial statements or in the footnotes; and
- **Interpretation**—Specifying use of a particular alternative provided in an IASC standard, or a particular interpretation in cases where the IASC standard is unclear or silent.

The resolution also establishes the notion of “waivers.” It states that, as part of national or regional specific requirements, waivers of particular aspects of an IASC standard may be envisaged, without requiring that the effect of the accounting method used be reconciled to the effect of applying the IASC method. The clear intention is that the use of waivers will be restricted to exceptional circumstances, such as issues identified by a domestic regulator when a specific IASC standard is contrary to domestic or regional regulation.

While more recently the move to converge IFRS and US GAAP has taken center stage, the IOSCO supplemental treatments remain extant for securities regulators to impose as deemed relevant to national interests. The following case study suggests one such scenario.

Company X has presented its financial statements under International Financial Reporting Standards (IFRS) and is seeking listing on the national stock exchange of Country Y. The securities regulator of Country Y is a member of the IOSCO. It has recently decided to accept financial statements prepared under IFRS. However, supplemental treatments as envisaged by the IOSCO recommendations would need to be made for the purposes of listings on its national stock exchange.

A local practitioner who is also knowledgeable about IAS was consulted by Company X. The consultant pointed out the following items that would need to be adjusted before the financial statements could be presented to the stock exchange in Country Y:

1. Amortization of intangible assets over twenty-five years by the company as permitted by IAS 38;
2. Revaluation of building with disclosures strictly according to IAS 16;
3. Immediate expensing of borrowing costs relating to certain qualifying assets as permitted by IAS 23; and
4. Use of the “true and fair” override with respect to translation of monetary liabilities. Accounts payable denominated in a foreign currency were not translated at year-end rates because that would have resulted in the company recognizing income of $2 million. Strictly applying IAS 21, this translation gain would need to be booked to income. However, since the company was certain that when it would ultimately repay these amounts such a difference in the amount payable would not result, and thus, recognizing this huge sum as income would not be proper. It therefore invoked the “true and fair” override provisions of IAS 1 and did not recognize this income.
The following possible supplemental adjustments are required before Company X is allowed to list its shares on the national stock exchange of Country Y:

1. The GAAP in Country Y allows intangible assets to be amortized over five years. Since the company has amortized the intangible assets over twenty-five years, a reconciliation is required as envisaged by the IOSCO recommendations;

2. Disclosures made in Company X’s financial statements under IAS 16 with respect to carrying amounts of a building based on cost would need to be supplemented by additional disclosures as envisioned in the IOSCO recommendations. For instance, additional disclosure with respect to significant balance sheet and income statement effect of revaluation would need to be provided;

3. Since the GAAP in Country Y only allows borrowing costs relating to qualifying assets to be capitalized, the financial statements prepared under IAS would need to be restated giving effect to this adjustment;

4. Because the GAAP in Country Y does not permit the “true and fair” override, the unrecognized income resulting from foreign currency translation gain would need to be booked in the income statement of Company X.
APPENDIX C

US GAAP RECONCILIATION AND RESTATEMENT—CASE STUDY

Hyderabad International Inc. prepares its financial statements in accordance with International Financial Reporting Standards (IFRS). The company wants to seek a listing on a US stock exchange. Therefore, it has approached an international financial reporting consultant, who specializes in both IFRS and US GAAP, to guide it in the reconciliation and restatement of its IFRS-based financial results to US GAAP. The approach taken by the consultant in restating the financial statements is very systematic and is based on the fundamental principles of double entry bookkeeping. In order to understand the logic behind the method employed by the consultant, one has to visualize the “opening” of the company’s general ledger for the accounting period and debiting and crediting various accounts. The objective is to restate the IFRS-based financial results to financial statements prepared in accordance with US GAAP. The balance sheet and the income statement of Hyderabad International Inc. for the latest financial period are presented below.

Exhibit 1

Hyderabad International Inc.
Balance Sheet (under IFRS)
December 31, 2004

(In DCU* Millions) (In DCU Millions)

Current assets:
- Cash and bank $ 500
- Accounts receivable 7,500
- Inventories 3,500
Total current assets $ 11,500

Current liabilities:
- Bank overdraft (1,000)
- Accounts payable (5,000)
- Accruals and provisions (4,000)
Total current liabilities (10,000)

Net current assets $ 1,500

Property, plant, and equipment 15,500
Accumulated depreciation (9,000)
Intangible assets 3,000
Accumulated amortization (1,000)
Long-term loans (3,000)

Shareholders’ equity:
- Equity capital 4,000
- Retained earnings 2,000
- Revaluation reserve 1,000
Total shareholders’ equity $ 7,000

* DCU are the Domestic Currency Units
Exhibit 2

Hyderabad International Inc.
Income Statement (under IFRS)
For the Year Ended December 31, 2004

(In DCU Millions)  (In DCU Millions)

Sales:  $27,000
Less: Cost of sales:  (15,000)
Gross profit:  13,000
Distribution costs:  5,000
Administrative expenses:  1,500

Operating expenses:
   Depreciation  $1,000
   Amortization:  1,000
   Staff costs:  1,500
   Other operating expenses:  1,500
   Total distribution, admin. & operating expenses:  $11,500

Income from operations:  1,500
Interest expense:  (700)
Interest income:  200
Net income for the period:  $1,000

Based on the differences noted between the two accounting frameworks, the IFRS/US GAAP consultant undertakes a restatement of the financial results. The following is a summary of some differences between IFRS and US GAAP identified by the consultant:

**Revaluation of buildings.** Under IAS 16, based on the “allowed alternative” treatment, property, plant, and equipment (PPE) can be revalued and carried from year to year at depreciated revalued amounts (instead of depreciated historical cost which is the prescribed treatment under the “benchmark treatment” of IAS 16). Although this treatment is followed in many countries including the UK, under US GAAP this practice would be regarded as a departure from GAAP. Consequently, when restating financial statements (initially prepared according to IFRS to financial statements prepared under US GAAP), the carrying amount of PPE that is revalued could be vastly different from the PPE carried at depreciated historical cost. Furthermore, depreciation charged to the Income Statement (when PPE is carried at revalued amounts) is comparatively higher. Thus, had the PPE been carried at depreciated historical cost (the way it is accounted for in the United States), the gross carrying amount of PPE would be lower by DCU 1,000 million compared to the IFRS-based figure. Also, for the year 2004, the depreciation charge would be lower by DCU 200 million compared to the IFRS-based depreciation expense.

The following journal entries are required in order to adjust the above:

**Journal Entry 1**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revaluation reserve: 1,000</td>
<td>Property, plant, &amp; equipment 1,000</td>
</tr>
<tr>
<td>Accumulated depreciation: 200</td>
<td>Retained earnings 100</td>
</tr>
<tr>
<td></td>
<td>Depreciation 100</td>
</tr>
</tbody>
</table>

**Research and development.** During the current year, the company incurred research and development (R&D) expenditure. Part of this qualified as development expenditure under IAS 38. Such expenses amounting to DCU 1,000 million were, in accordance with IAS 38, treated as intangible assets. This is not the treatment prescribed by US GAAP that mandates that such expenses should be expensed when incurred and not allowed to be carried forward. Thus, on restating financial statements prepared in accordance with IFRS (to financial statements based on US GAAP), DCU 1,000 million would need to be reversed
from intangible assets and charged to expenses (e.g., to “Other Operating Expenses”). The company amortized these capitalized “development costs” (treated as an intangible asset) over a period of five years using the straight-line method. For the year 2004, it charged an amortization expense of DCU 200 million to the income statement. This needs to be reversed.

The following journal entry illustrates the above adjustment:

**Journal Entry 2**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other operating expenses</td>
<td>1,000</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>1,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>200</td>
</tr>
<tr>
<td>Amortization</td>
<td>200</td>
</tr>
</tbody>
</table>

**Expensed “in-process” R&D versus intangible asset or goodwill.** During the previous financial year the company acquired a “dot.com” enterprise. Part of the acquisition price was attributed to in-process research and development (R&D). Under IAS 22, *acquired* in-process R&D is either a separately identifiable intangible asset or part of goodwill. (Note that for acquisitions after March 2004 the provisions of IFRS 3 apply, superseding IAS 22. However, regarding this matter, the prescribed treatments are essentially the same under both former and new standards.) However, under US GAAP, *acquired* in-process R&D is never recognized as an asset but is separated from goodwill and recognized as an expense in the year of acquisition. The company’s accounting policy is to initially capitalize *acquired* in-process R&D as an intangible asset and later amortize it. Thus, the company capitalized in-process R&D of DCU 1,000 million on the acquisition of the dot.com enterprise in the previous financial year. It amortized this intangible asset over a period of five years using the straight-line method. Considering the treatment required under US GAAP (i.e., to expense *acquired* in-process R&D), the IFRS/US GAAP consultant (retained by the company) estimated that intangible assets were overstated (as of December 31, 2004) by DCU 600 million and that the net income for 2004 was understated by DCU 200 million. Further, the previous year’s net income was overstated by DCU 800 million according to the consultant.

Based on the opinion of the consultant the following journal entry was recorded:

**Journal Entry 3**

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained earnings</td>
<td>1,000</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>1,000</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>400</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>200</td>
</tr>
<tr>
<td>Amortization</td>
<td>200</td>
</tr>
</tbody>
</table>

**Borrowing costs.** Under IAS 23, borrowing costs relating to qualifying assets can either be expensed (under the benchmark treatment) or capitalized (under the allowed alternative treatment). In the United States, such borrowing costs are capitalized and added to the carrying amount of the related qualifying asset. During the current year, the construction of a qualifying asset (as defined in IAS 23) was completed. Interest expense on long-term borrowings utilized in the construction of the qualifying asset were expensed by the company in accordance with the benchmark treatment of IAS 23. The interest expense that was charged to the income statement in the previous financial period amounted to DCU 75 million and the interest expenses during the current year totaled DCU 25 million. The qualifying asset has a useful life of five years and is depreciated using the straight-line method.

The following adjusting entry is required in order to adjust the above treatment of borrowing costs under IFRS:
Journal Entry 4

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Property, plant, &amp; equipment</td>
<td>100</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>75</td>
</tr>
<tr>
<td>Interest expense</td>
<td>25</td>
</tr>
<tr>
<td>Depreciation</td>
<td>20</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>20</td>
</tr>
</tbody>
</table>

Foreign exchange differences—capitalization of losses from severe currency devaluation. At the end of the previous financial year the company imported machinery on deferred credit terms. The liability in foreign currency was carried forward to the current financial year. During the current financial year the currency of the country importing the machinery underwent severe devaluation. As a result, the company paid an extra sum of DCU 25 million over and above the contracted foreign currency liability relating to the imported machinery that was carried forward (as a foreign currency denominated payable) from the previous year. There was no practical means of hedging against this devaluation. Since this machinery was placed in service on the last day of the current financial year, no depreciation was charged on this asset.

Previously there had been an allowed alternative treatment in IAS 21, so that in rare circumstances, foreign exchange losses were allowed to be included in the carrying amount of a recently acquired asset. Such foreign exchange differences were to have resulted from “severe devaluation or depreciation of a currency against which there is no practical means of hedging and that affects liabilities which cannot be settled and which arise directly on the recent acquisition of an asset invoiced in a foreign currency.” SIC 11 had clarified, among other issues, the meaning of the term “recent acquisition” used in IAS 21 and interpreted it as a period not exceeding twelve months.

Revised IAS 21 has eliminated this option, and recognition of the effects of exchange differences have to be included in current period earnings. The revisions to IAS 21 are effective in 2005. For purposes of this example, assume the differences arise before 2005 and that the now-eliminated option was elected by the reporting entity.

Under US GAAP, capitalization of foreign currency losses is not permitted. In other words, while restating financial statements in accordance with US GAAP, such foreign exchange differences would need to be charged to the income statement.

The consultant has suggested the following journal entry to take care of the above IFRS treatment:

Journal Entry 5

<table>
<thead>
<tr>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other operating expenses</td>
<td>25</td>
</tr>
<tr>
<td>Property, plant, &amp; equipment</td>
<td>25</td>
</tr>
</tbody>
</table>
### Exhibit 3

Hyderabad International Inc.
Restated Balance Sheet (per US GAAP)
December 31, 2004 (in DCU Millions)

<table>
<thead>
<tr>
<th></th>
<th>Before restatement (per IFRS)</th>
<th>Debit</th>
<th>JE #</th>
<th>Credit</th>
<th>JE #</th>
<th>Restated (per US GAAP)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current assets:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cash and bank</td>
<td>500</td>
<td></td>
<td>100</td>
<td>1,000</td>
<td>1</td>
<td>500</td>
</tr>
<tr>
<td>Accounts receivable</td>
<td>7,500</td>
<td></td>
<td>25</td>
<td>20</td>
<td>4</td>
<td>7,500</td>
</tr>
<tr>
<td>Inventories</td>
<td>3,500</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3,500</td>
</tr>
<tr>
<td>Total current assets</td>
<td>$11,500</td>
<td></td>
<td></td>
<td>$14,575</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Property, plant, &amp; equipment</strong></td>
<td>$15,500</td>
<td>200</td>
<td>1</td>
<td>20</td>
<td>4</td>
<td>($8,820)</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
<td>(9,000)</td>
<td>200</td>
<td>1</td>
<td>20</td>
<td>4</td>
<td>(8,575)</td>
</tr>
<tr>
<td>Intangible assets</td>
<td>3,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5,755</td>
</tr>
<tr>
<td>Accumulated amortization</td>
<td>(1,000)</td>
<td>400</td>
<td>3</td>
<td></td>
<td></td>
<td>(400)</td>
</tr>
<tr>
<td>Total</td>
<td>$20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$17,855</td>
</tr>
<tr>
<td><strong>Liabilities &amp; Equity</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Current liabilities:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bank overdraft</td>
<td>1,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1,000</td>
</tr>
<tr>
<td>Accounts payable</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Accruals and provisions</td>
<td>4,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4,000</td>
</tr>
<tr>
<td>Total current liabilities</td>
<td>$10,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$10,000</td>
</tr>
<tr>
<td><strong>Long-term loans</strong></td>
<td>3,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>3,000</td>
</tr>
<tr>
<td><strong>Shareholders’ equity:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Equity capital</td>
<td>4,000</td>
<td></td>
<td>200</td>
<td>75</td>
<td>4</td>
<td>4,000</td>
</tr>
<tr>
<td>Retained earnings</td>
<td>2,000</td>
<td>1,000</td>
<td>3</td>
<td>100</td>
<td>1</td>
<td>2,000</td>
</tr>
<tr>
<td>Increase in net profit</td>
<td>520</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>855</td>
</tr>
<tr>
<td>Revaluation reserve</td>
<td>1,000</td>
<td>1,000</td>
<td>1</td>
<td></td>
<td></td>
<td>$4,655</td>
</tr>
<tr>
<td>Total</td>
<td>$7,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$7,000</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>$20,000</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>$17,855</td>
</tr>
</tbody>
</table>
### Exhibit 4

**Hyderabad International Inc.**  
**Restated Income Sheet (per US GAAP)**  
**Year Ended December 31, 2004 (in DCU Millions)**

<table>
<thead>
<tr>
<th>Before restatement (per IFRS)</th>
<th>Debit</th>
<th>JE #</th>
<th>Credit</th>
<th>JE #</th>
<th>Restated (per US GAAP)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$27,000</td>
<td></td>
<td></td>
<td></td>
<td>$27,000</td>
</tr>
<tr>
<td>Less: Cost of sales</td>
<td>(15,000)</td>
<td></td>
<td></td>
<td></td>
<td>(15,000)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>$12,000</td>
<td></td>
<td></td>
<td></td>
<td>$12,000</td>
</tr>
<tr>
<td>Distribution costs</td>
<td>5,000</td>
<td></td>
<td></td>
<td></td>
<td>5,000</td>
</tr>
<tr>
<td>Administrative expenses</td>
<td>1,500</td>
<td></td>
<td></td>
<td></td>
<td>1,500</td>
</tr>
<tr>
<td><strong>Operating expenses</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>$1,000</td>
<td>20</td>
<td>4</td>
<td>100</td>
<td>1</td>
</tr>
<tr>
<td>Amortization</td>
<td>1,000</td>
<td>200</td>
<td>2</td>
<td>200</td>
<td>3</td>
</tr>
<tr>
<td>Staff costs</td>
<td>1,500</td>
<td></td>
<td></td>
<td></td>
<td>1,500</td>
</tr>
<tr>
<td>Other operating expenses</td>
<td>1,500</td>
<td>25</td>
<td>5</td>
<td>25</td>
<td>2,525</td>
</tr>
<tr>
<td><strong>Total distribution, admin. and operating expenses</strong></td>
<td>$11,500</td>
<td></td>
<td></td>
<td></td>
<td>$12,045</td>
</tr>
<tr>
<td>Income from operations</td>
<td>$1,500</td>
<td></td>
<td></td>
<td></td>
<td>955</td>
</tr>
<tr>
<td>Interest expense</td>
<td>(700)</td>
<td>25</td>
<td>4</td>
<td></td>
<td>(675)</td>
</tr>
<tr>
<td>Interest income</td>
<td>200</td>
<td></td>
<td></td>
<td></td>
<td>200</td>
</tr>
<tr>
<td><strong>Net income for the period</strong></td>
<td>$1,000</td>
<td></td>
<td></td>
<td></td>
<td>$480</td>
</tr>
</tbody>
</table>

### Exhibit 5

**Hyderabad International Inc.**  
**Reconciliation of Net Profit Determined under International Accounting Standards to Net Income in Accordance with US GAAP (in DCU millions)**

<table>
<thead>
<tr>
<th>Adjustments to conform to US GAAP</th>
<th>JE #</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td></td>
<td>Excess depreciation on revalued PPE reversed</td>
</tr>
<tr>
<td>2</td>
<td></td>
<td>Capitalized R&amp;D expensed (plus reversal of amortization)</td>
</tr>
<tr>
<td>3</td>
<td></td>
<td>Adjustment relating to acquired in-process R&amp;D</td>
</tr>
<tr>
<td>4</td>
<td></td>
<td>Expensed borrowing costs on qualifying assets capitalized</td>
</tr>
<tr>
<td>5</td>
<td></td>
<td>Capitalized foreign currency losses (from severe devaluation) reversed</td>
</tr>
</tbody>
</table>

Net income in accordance with US GAAP (480)
APPENDIX D

USE OF PRESENT VALUE IN ACCOUNTING

Present value is a pervasive concept that has many applications in accounting. Currently, IFRS does not provide specific guidance to this subject matter, but in recognition of its importance, guidance drawn from US GAAP’s Concepts Statement 7 (CON 7) is summarized on the following pages.

CON 7 provides a framework for using estimates of future cash flows as the basis for accounting measurements either at initial recognition or when assets are subsequently re-measured at fair value (fresh-start measurements). It also provides a framework for using the interest method of amortization. It provides the principles that govern measurement using present value, especially when the amount of future cash flows, their timing, or both are uncertain. However, it does not address recognition questions, such as which transactions and events should be valued using present value measures or when fresh-start measurements are appropriate.

Fair value is the objective for most measurements at initial recognition and for fresh-start measurements in subsequent periods. At initial recognition, the cash paid or received (historical cost or proceeds) is usually assumed to be fair value, absent evidence to the contrary. For fresh-start measurements, a price that is observed in the marketplace for an essentially similar asset or liability is fair value. If purchase prices and market prices are available, there is no need to use alternative measurement techniques to approximate fair value. However, if alternative measurement techniques must be used for initial recognition and for fresh-start measurements, those techniques should attempt to capture the elements that when taken together would comprise a market price if one existed. The objective is to estimate the price likely to exist in the marketplace if there were a marketplace—fair value.

CON 7 states that the only objective of using present value in accounting measurements is fair value. It is necessary to capture, to the extent possible, the economic differences in the marketplace between sets of estimated future cash flows. A present value measurement that fully captures those differences must include the following elements:

1. An estimate of the future cash flow, or in more complex cases, series of future cash flows at different times
2. Expectations about possible variations in the amount or timing of those cash flows
3. The time value of money, represented by the risk-free rate of interest
4. The risk premium—the price for bearing the uncertainty inherent in the asset or liability
5. Other factors, including illiquidity and market imperfections

How CON 7 measures differ from previously utilized present value techniques. Previously employed present value techniques typically used a single set of estimated cash flows and a single discount (interest) rate. In applying those techniques, adjustments for factors 2. through 5. described in the previous paragraph are incorporated in the selection of the discount rate. In the CON 7 approach, only the third factor listed (the time value of money) is included in the discount rate; the other factors cause adjustments in arriving at risk-adjusted expected cash flows. CON 7 introduces the probability-weighted, expected cash flow approach, which focuses on the range of possible estimated cash flows and estimates of their respective probabilities of occurrence.

Previous techniques used to compute present value used estimates of the cash flows most likely to occur. CON 7 refines and enhances the precision of this model by weighting different cash flow scenarios (regarding the amounts and timing of cash flows) by their estimated probabilities of occurrence and factoring these scenarios into the ultimate determina-
tion of fair value. The difference is that values are assigned to the cash flows other than the most likely one. To illustrate, a cash flow might be €100, €200, or €300 with probabilities of 10%, 50% and 40%, respectively. The most likely cash flow is the one with 50% probability, or €200. The expected cash flow is €230 (€100 × .1) + (€200 × .5) + (€300 × .4).

The CON 7 method, unlike previous present value techniques, can also accommodate uncertainty in the timing of cash flows. For example, a cash flow of €10,000 may be received in one year, two years, or three years with probabilities of 15%, 60%, and 25%, respectively. Traditional present value techniques would compute the present value using the most likely timing of the payment—two years. The example below shows the computation of present value using the CON 7 method. Again, the expected present value of €9,030 differs from the traditional notion of a best estimate of €9,070 (the 60% probability) in this example.

<table>
<thead>
<tr>
<th>Present value of €10,000 in one year discounted at 5%</th>
<th>€9,523</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multiplied by 15% probability</td>
<td>€1,428</td>
</tr>
<tr>
<td>Present value of €10,000 in two years discounted at 5%</td>
<td>9,070</td>
</tr>
<tr>
<td>Multiplied by 60% probability</td>
<td>5,442</td>
</tr>
<tr>
<td>Present value of €10,000 in three years discounted at 5%</td>
<td>8,638</td>
</tr>
<tr>
<td>Multiplied by 25% probability</td>
<td>2,160</td>
</tr>
<tr>
<td>Probability weighted expected present value</td>
<td>€9,030</td>
</tr>
</tbody>
</table>

Measuring liabilities. The measurement of liabilities involves different problems from the measurement of assets; however, the underlying objective is the same. When using present value techniques to estimate the fair value of a liability, the objective is to estimate the value of the assets required currently to (1) settle the liability with the holder or (2) transfer the liability to an entity of comparable credit standing. To estimate the fair value of an entity’s notes or bonds payable, accountants look to the price at which other entities are willing to hold the entity’s liabilities as assets. For example, the proceeds of a loan are the price that a lender paid to hold the borrower’s promise of future cash flows as an asset.

The most relevant measurement of an entity’s liabilities should always reflect the credit standing of the entity. An entity with a good credit standing will receive more cash for its promise to pay than an entity with a poor credit standing. For example, if two entities both promise to pay €750 in three years with no stated interest payable in the interim, Entity A, with a good credit standing, might receive about €630 (a 6% interest rate). Entity B, with a poor credit standing, might receive about €533 (a 12% interest rate). Each entity initially records its respective liability at fair value, which is the amount of proceeds received—an amount that incorporates that entity’s credit standing.

Present value techniques can also be used to value a guarantee of a liability. Assume that Entity B in the above example owes Entity C. If Entity A were to assume the debt, it would want to be compensated €630—the amount that it could get in the marketplace for its promise to pay €750 in three years. The difference between what Entity A would want to take the place of Entity B (€630) and the amount that Entity B receives (€533) is the value of the guarantee (€97).

Interest method of allocation. CON 7 describes the factors that suggest that an interest method of allocation should be used. It states that the interest method of allocation is more relevant than other methods of cost allocation when it is applied to assets and liabilities that exhibit one or more of the following characteristics:

1. The transaction is, in substance, a borrowing and lending transaction.
2. Period-to-period allocation of similar assets or liabilities employs an interest method.
3. A particular set of estimated future cash flows is closely associated with the asset or liability.

4. The measurement at initial recognition was based on present value.

**Accounting for changes in expected cash flows.** If the timing or amount of estimated cash flows changes and the asset or liability is not remeasured at a fresh-start measure, the interest method of allocation should be altered by a catch-up approach. That approach adjusts the carrying amount to the present value of the revised estimated future cash flows, discounted at the original effective interest rate.

**Application of present value tables and formulas.**

**Present value of a single future amount.** To take the present value of a single amount that will be paid in the future, apply the following formula; where \( PV \) is the present value of €1 paid in the future, \( r \) is the interest rate per period, and \( n \) is the number of periods between the current date and the future date when the amount will be realized.

\[
PV = \frac{1}{(1 + r)^n}
\]

In many cases the results of this formula are summarized in a present value factor table.

<table>
<thead>
<tr>
<th>( n )</th>
<th>( 2% )</th>
<th>( 3% )</th>
<th>( 4% )</th>
<th>( 5% )</th>
<th>( 6% )</th>
<th>( 7% )</th>
<th>( 8% )</th>
<th>( 9% )</th>
<th>( 10% )</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>0.9804</td>
<td>0.9709</td>
<td>0.9615</td>
<td>0.9524</td>
<td>0.9434</td>
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</tbody>
</table>

**Example**

Suppose one wishes to determine how much would need to be invested today to have €10,000 in five years if the sum invested would earn 8%. Looking across the row with \( n = 5 \) and finding the present value factor for the \( r = 8\% \) column, the factor of 0.6806 would be identified. Multiplying €10,000 by 0.6806 results in €6,806, the amount that would need to be invested today to have €10,000 at the end of five years. Alternatively, using a calculator and applying the present value of a single sum formula, one could multiply €10,000 by \( 1/(1 + .08)^5 \), which would also give the same answer—€6,806.

**Present value of a series of equal payments (an annuity).** Many times in business situations a series of equal payments paid at equal time intervals is required. Examples of these include payments of semiannual bond interest and principal or lease payments. The present value of each of these payments could be added up to find the present value of this annuity, or alternatively a much simpler approach is available. The formula for calculating the present value of an annuity of €1 payments over \( n \) periodic payments, at a periodic interest rate of \( r \) is

\[
PV\ Annuity = \frac{1}{(1 + r)^n} \left(1 - \frac{1}{(1 + r)^n}\right)
\]

The results of this formula are summarized in an annuity present value factor table.

<table>
<thead>
<tr>
<th>( n )</th>
<th>( 2% )</th>
<th>( 3% )</th>
<th>( 4% )</th>
<th>( 5% )</th>
<th>( 6% )</th>
<th>( 7% )</th>
<th>( 8% )</th>
<th>( 9% )</th>
<th>( 10% )</th>
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</table>
Example
Suppose four annual payments of €1,000 will be needed to satisfy an agreement with a supplier. What would be the amount of the liability today if the interest rate the supplier is charging is 6% per year? Using the table to get the present value factor, then n = 4 periods row, and the 6% column, gives you a factor of 3.4651. Multiply this by €1,000 and you get a liability of €3,465.10 that should be recorded. Using the formula would also give you the same answer with r = 6% and n = 4.

Caution must be exercised when payments are not to be made on an annual basis. If payments are on a semiannual basis n = 8, but r is now 3%. This is because r is the periodic interest rate, and the semiannual rate would not be 6%, but half of the 6% annual rate. Note that this is somewhat simplified, since due to the effect of compound interest 3% semiannually is slightly more than a 6% annual rate.

Example of the relevance of present values
A measurement based on the present value of estimated future cash flows provides more relevant information than a measurement based on the undiscounted sum of those cash flows. For example, consider the following four future cash flows, all of which have an undiscounted value of €100,000:

1. Asset A has a fixed contractual cash flow of €100,000 due tomorrow. The cash flow is certain of receipt.
2. Asset B has a fixed contractual cash flow of €100,000 due in twenty years. The cash flow is certain of receipt.
3. Asset C has a fixed contractual cash flow of €100,000 due in twenty years. The amount that ultimately will be received is uncertain. There is an 80% probability that the entire €100,000 will be received. There is a 20% probability that €80,000 will be received.
4. Asset D has an expected cash flow of €100,000 due in twenty years. The amount that ultimately will be received is uncertain. There is a 25% probability that €120,000 will be received. There is a 50% probability that €100,000 will be received. There is a 25% probability that €80,000 will be received.

Assuming a 5% risk-free rate of return, the present values of the assets are

1. Asset A has a present value of €99,986. The time value of money assigned to the one-day period is €14(€100,000 × .05/365 days).
2. Asset B has a present value of €37,689 [€100,000/(1 + .05)²⁰].
3. Asset C has a present value of €36,181 [(€100,000 × .8 + 80,000 × .2)/(1 + .05)²⁰].
4. Asset D has a present value of €37,689 [(€120,000 × .25 + 100,000 × .5 + 80,000 × .25)/(1 + .05)²⁰].

Although each of these assets has the same undiscounted cash flows, few would argue that they are economically the same or that a rational investor would pay the same price for each. Investors require compensation for the time value of money. They also require a risk premium. That is, given a choice between Asset B with expected cash flows that are certain and Asset D with cash flows of the same expected amount that are uncertain, investors will place a higher value on Asset B, even though they have the same expected present value. CON 7 says that the risk premium should be subtracted from the expected cash flows before applying the discount rate. Thus, if the risk premium for Asset D was €500, the risk-adjusted present values would be €37,500 {[(€120,000 × .25 + 100,000 × .5 + 80,000 × .25) − 500]/(1 + .05)²⁰].

Practical matters. Like any accounting measurement, the application of an expected cash flow approach is subject to a cost-benefit constraint. The cost of obtaining additional information must be weighed against the additional reliability that information will bring to the measurement. As a practical matter, an entity that uses present value measurements often has little or no information about some or all of the assumptions that investors would use in assessing the fair value of an asset or a liability. Instead, the entity must use the information
that is available to it without undue cost and effort when it develops cash flow estimates. The entity’s own assumptions about future cash flows can be used to estimate fair value using present value techniques, as long as there are no contrary data indicating that investors would use different assumptions. However, if contrary data exist, the entity must adjust its assumptions to incorporate that market information.