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ACCOUNTING NEWS

NEW RULES MAKE HEDGE ACCOUNTING EASIER

IN NOVEMBER 2013, THE INTERNATIONAL ACCOUNTING STANDARDS BOARD (IASB) PUBLISHED IFRS 9 *FINANCIAL INSTRUMENTS* (HEDGE ACCOUNTING AND AMENDMENTS TO IFRS 9, IFRS 7 AND IAS 39), INCORPORATING THE NEW HEDGE ACCOUNTING REQUIREMENTS AND DEFERRING THE EFFECTIVE DATE OF IFRS 9.

Deferral of the effective date for IFRS 9

The effective date of IFRS 9 has been deleted. This is because the impairment phase of IFRS 9 is not yet finalised and the existing mandatory effective date of 1 January 2015 would not allow sufficient time for entities to prepare to apply IFRS 9 (the IASB normally leaves a period of at least 18 months between the date of issue of a finalised IFRS, and the start of the period of its adoption). The IASB therefore deleted the existing 2015 effective date and has left the revised effective date open until all the other outstanding phases of IFRS 9 have been finalised. Early application of IFRS 9 is still permitted.

New hedge accounting model

The new hedge accounting requirements added to IFRS 9 are more principles-based, less complex and provide a better link to risk management and treasury operations than the requirements in IAS 39 *Financial Instruments: Recognition and Measurement*. The new model allows entities to apply hedge accounting more broadly to manage profit or loss mismatches, and as a result, reduce 'artificial' hedge ineffectiveness that can arise under IAS 39.

Key changes introduced by the new model include:

- Simplified effectiveness testing, including removal of the 80-125% highly effective threshold
- More items qualify for hedge accounting, e.g. pricing components within a non-financial item, and net foreign exchange cash positions
- Entities can more effectively hedge account exposures that give rise to two risk positions (e.g. interest rate risk and foreign exchange risk, or commodity risk and foreign exchange risk) that are managed by separate derivatives over different periods
- Less profit or loss volatility when using options, forwards and foreign currency swaps
- New alternatives available for economic hedges of credit risk and 'own use' contracts which will reduce profit or loss volatility.

Depending on an entity's risk management strategy, the cost of applying hedge accounting is likely to be lower for entities with relatively simple risk management strategies. Entities that are most likely to be able to achieve hedge accounting under the new requirements include:

- Entities in the mining and natural resources sector, airlines, agriculture and other commodities industries, including those entities wishing to hedge diesel
- Entities with significant foreign currency transactions or foreign currency funding that use derivatives to manage risk in their business activities
- Less sophisticated entities with 'vanilla' interest rate swaps.

The new hedging requirements in IFRS 9 are available for early adoption, provided the classification and measurement requirements in IFRS 9 are also adopted at the same time, because IFRS 9 needs to be adopted as a complete package.

The significant change in the way options are to be accounted for is likely to give rise to the introduction of far more option products, including caps/floors/collars on interest rates, commodity and FX exposure.

IN THIS EDITION

In this edition, we look at the new hedge accounting rules released at the end of November by the International Accounting Standards Board (IASB). We give a round-up of new and amended accounting standards and interpretations that may impact your 31 December 2013 annual and half-year financial statements. We also look at ASIC's recent Information Sheet 183 *Directors and Financial Reporting* which provides guidance to directors on their financial reporting responsibilities.

What remains unchanged?

While there are some fundamental changes to the hedge accounting model, the general accounting mechanics of hedge accounting remains largely unchanged:

- The new model retains the cash flow, fair value and net investment hedge accounting mechanics
- Entities are still required to measure hedge effectiveness and recognise any ineffectiveness in profit or loss
- Hedge documentation is still required
- Hedge accounting will remain optional.

Changes from IAS 39

Effectiveness testing

The 80-125% quantitative threshold criteria for applying hedge accounting under IAS 39 has been removed. To qualify for hedge accounting under the new model, the hedge transaction must meet the following criteria:

- There is an economic relationship between the hedged item and the hedging instrument, i.e. the hedging instrument must be expected to have offsetting fair values
- The fair value changes due to credit risk should not be a significant driver of the fair value changes of either the hedging instrument or the hedged item
- The hedge ratio shall be designated based on actual quantities of the hedged item and hedging instrument. This means that the hedge ratio applied for hedge accounting purposes should be the same as the hedge ratio used for risk management purposes. For example, an entity enters into a $10 million pay-fixed-receive-floating interest rate swap to manage its exposure to floating interest rates arising from a $10 million floating interest rate loan. The entity would designate the following:
  - Hedged item: $10 million floating interest rate loan
  - Hedging instrument: $10 million pay-fixed-receive-floating interest rate swap.

Under the new requirements, hedge effectiveness testing will only be required prospectively. For simple hedge relationships, entities are expected to be able to apply a qualitative test (e.g. critical terms match where the risk, quantity and timing of the hedged item matches the hedging instrument). For more complex hedging relationships e.g. where the hedged item is of a different grade to the hedging instrument (i.e. where a basis difference exists), a more detailed quantitative test is likely to be required.

Rebalancing

Rebalancing is a new concept introduced under the new model. It refers to the prospective altering of the hedge ratio (either by changing the quantities of the hedged item or the hedging instrument) without discontinuing/terminating the existing hedge accounting relationship. The new model requires rebalancing when there is a change in the economic relationship between the hedged item and the hedging instrument such that it leads to an adjustment of the economic hedge ratio.

Hedged items

The new model allows more items to qualify as eligible hedged items compared to IAS 39.

Risk components

IFRS 9 now allows risk components of non-financial items to qualify for hedge accounting. Previously under IAS 39, only risk components of financial items qualified for hedge accounting. To be an eligible risk component, the risk component needs to be separately identifiable and reliably measurable. The eligible risk component can be contractually or non-contractually specified. Examples of non-contractually specified risk components include the crude oil component in jet fuel prices, and the gasoline component in diesel fuel prices.

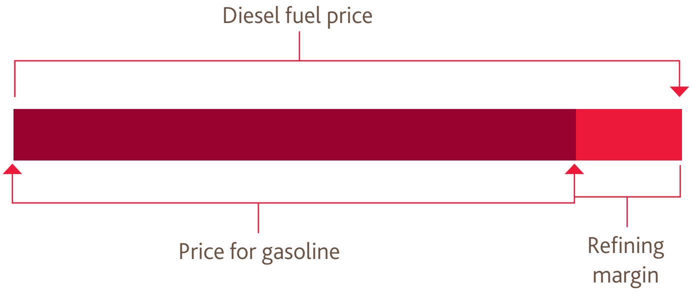
Example 1: Contractually specified risk component

Entity A enters into contracts to purchase 100 tonnes of coffee in six months time. The contract price for the coffee is based on the pricing formula: Coffee C ICE futures + 5% logistics fee. Entity A enters into Coffee C ICE futures to hedge the variability in the coffee price.

Under IFRS 9, the Coffee C ICE futures can be separately identified as a contractually specified component of the pricing contract, therefore Entity A can designate the Coffee C ICE futures as a hedged item. This means that Entity A will compare fair value changes of the coffee futures component of the contract (hedged item) against the fair value changes of the coffee futures derivative that it has taken out (hedging instrument) giving greater offset than under IAS 39. Under IAS 39, Entity A would have to compare the fair value changes of the entire contract against the fair value changes of the coffee derivative.

Example 2: Non-contractually specified risk component

M&E Ltd enters into contracts to purchase diesel. The market structure of the diesel fuel price includes gasoline as an identifiable price component within the diesel fuel price. To hedge the variability in gasoline prices, M&E Ltd enters into gasoline futures. Under the new model, M&E Ltd can designate the gasoline component as the hedged item (under IAS 39 you can only designate the diesel contract as the hedged item) which means M&E Ltd will compare value changes of the gasoline derivative against the fair value changes of gasoline as the hedged item giving it greater offset than under IAS 39.



Aggregated exposures

An aggregated exposure is a combination of a derivative item and a non-derivative item. Under IAS 39, derivatives cannot be designated as hedged items. IFRS 9 allows an entity to designate an exposure that combines a derivative and a non-derivative (known as an aggregated exposure) as a hedged item, provided that aggregated exposure is managed as one exposure. This change allows entities to more effectively hedge account exposures that give rise to two risk positions (e.g. interest rate risk and foreign exchange risk, or commodity risk and foreign exchange risk) that are managed by separate derivatives over different periods.

Example 3: Aggregated exposures

Entity B is an Australian entity. It issues private placement bonds in the USA with a maturity of 10 years, paying a fixed interest rate of 5%. To manage the foreign exchange risk from the USD denominated debt, Entity C enters into a 10 year cross currency interest rate swap (CCIRS). The CCIRS pays floating interest rate payments in AUD and receives fixed USD interest payments.

Entity B's interest rate risk management strategy is to fix interest payments in AUD from years 2-5. So Entity B enters into a second derivative instrument, an interest rate swap, which pays fixed interest AUD payments and receives floating interest AUD payments, effectively swapping the AUD floating interest payments from the CCIRS in years 2-5, to fixed interest payments in AUD.

Under IFRS 9, Entity B would be able to designate the following relationships:

- First hedging relationship – to mitigate the exposure to foreign exchange rate risk
  - Hedged item: 10 year fixed rate USD debt
  - Hedging instrument: 10 year CCIRS
- Second hedging relationship – to mitigate the exposure to AUD interest rate risk in years 2-5
  - Hedged item: Floating interest rate AUD payments (years 2-5) - the aggregated exposure
  - Hedging instrument: Pay-fixed–receive-floating interest AUD swap.

Hedging instruments

Options

The price of an option contains two components: the intrinsic value and the time value. Under IFRS 9, an entity can designate only the intrinsic value component as the hedging instrument (which gives greater offset), and defer the initial time value of the option in other comprehensive income (OCI). The initial time value is then accounted for differently, depending on the nature of the hedged item:

- If the hedged item is **transaction-related**, for example, it is a forecast sale of a commodity, the initial time value is deferred in OCI and capitalised into the cost of the hedged item
- If the hedged item is **time period-related**, for example, it is to cap interest at a certain level, the initial time value is deferred in OCI and amortised over the term of the hedging relationship.

The subsequent changes in the time value component during the life of the hedge are recorded in OCI whereas under IAS 39, the changes in the time value component are recognised in profit or loss.

HEDGED ITEM	INITIAL TIME VALUE	EXAMPLE
Transaction-related	Capitalise into the cost of the hedged item	Forecast sale of a commodity
Time period-related	Amortise over the term of the hedging relationship	Floating interest rate loan

Example 4: Time value of options

Gold Ltd is based in Western Australia and it has a producing gold mine. In anticipation of sales to be made in 12 months, and to protect itself from possible decrease in gold prices, it purchased at-the-money gold put options that expire in 12 months. Gold Ltd paid a premium of $10 for the gold options, which is its time value. So at the start of the hedge, Gold Ltd would defer the initial time value of the option ($10) in OCI.

Assuming 100% hedge effectiveness, subsequently Gold Ltd would:

- Record gold put options at fair value (i.e. marked-to-market) in the statement of financial position
- Also split the options' fair value into its:
  - Intrinsic value component
  - Time value component
- Record the changes in the intrinsic value component in the cash flow hedge reserve
- Record the changes in the time value component in a separate component in OCI.

At the end of the hedge, the initial time value ($10) is transferred and adjusted against the gold sales revenue.

Forwards

Forwards also have two components: the spot component and the forward points component. The new hedging requirements permit that when an entity only designates the spot element as the hedging instrument, the initial forward points can be deferred in OCI and amortised over the period of the hedging relationship. Subsequent changes in forward points will be recognised in OCI and not in profit or loss. For example, an entity takes out a forward contract to hedge a foreign currency loan to an overseas subsidiary that forms part of the net investment in the overseas subsidiary under IAS 21 *Effects of Changes in Foreign Exchange Rates*. Under IAS 21, the loan will be remeasured at the spot FX rate at year end so the entity only designates the spot element of the forward contract as the hedging instrument to offset the spot FX movements in the foreign currency loan. Under the new requirements, the changes in the forward points are recognised in OCI. Under IAS 39, the changes in forward points are recognised in profit or loss. Therefore, the new requirement for forward points will result in less profit or loss volatility.

Foreign currency swaps

The foreign currency (FX) basis spread is a pricing element in foreign currency swaps (e.g. foreign currency interest rate swaps) that reflects the 'cost' of exchanging two currencies. It arises mainly due to the demand and supply of different currencies and the perceived credit risk of different reference rates/main players (large financial institutions) in the FX market. The FX basis spread results in volatility in the hedging instrument (especially in recent times) not mirrored in the hedged item, creating hedge ineffectiveness.

Under the new model, entities can apply the same accounting as forward points to the FX basis spread component of a foreign currency swap when designating the foreign currency swap as a hedging instrument. This means that the initial FX basis spread component can be amortised over the period of the hedging relationship with subsequent changes in the FX basis spread recognised in OCI. This means reduced profit or loss volatility and changes in the FX basis spread will not result in additional hedge 'ineffectiveness'.

Groups and net positions

IAS 39 *Financial Instruments: Recognition and Measurement* contains very restrictive rules on hedging groups of items:

- It requires that each individual item in the group has value changes on the hedged risk that are approximately proportional to that of the group as a whole e.g. a basket of shares cannot be designated as a group against market index futures because the individual shares do not necessarily move in the same direction as the market index
- It does not allow entities to hedge net positions when risks within the group naturally offset to some degree so that only the remaining net risk is hedged.

The requirements in IFRS 9 *Financial Instruments:*

- Removes the IAS 39 restriction on groups e.g. a basket of shares can now be designated as a group against market index derivatives (previously under IAS 39, this could not be done)
- Permits fair value hedges of net positions (e.g. a portfolio of financial assets and liabilities or the net position of a group of firm commitments for purchases and sales in the same foreign currency)
- Permits cash flow hedges of a net position for foreign exchange risk, but entities must specify at the start, how and when each of the items that make up the net position will affect profit or loss.

For net position hedges under IFRS 9, any reclassification of the hedging instrument gains or losses into profit or loss is presented in a separate line item in the profit or loss section of the statement of profit or loss and other comprehensive income, i.e. not adjusted to the related individual line items.

Example 5: Hedges of net FX cash flow position

On 1/3/2014 Entity E hedges a net foreign currency (FC) 2 million position which comprises the following forecast transactions:

	FC
Expected sales (spread evenly over the next six mths)	7 million
Expected inventory purchases (spread evenly over the next six mths)	3 million
Expected machinery purchase (30/9/2014)	2 million

Entity E enters into a FC 2m foreign currency (FX) forward contract settling on 30/9/2014.

Under IFRS 9, Entity E can designate all cash flows in the table as hedged items in a single cash flow hedge (net position hedge) and designate the FX forward contract as the hedging instrument. The eventual sales and purchases are reflected at the spot rate at the time of the transaction and not at the hedged rate. The gain or loss from the derivative at the hedged rate (i.e. the difference between the hedged rate and the spot rate) is presented in a separate line item in the profit or loss section of the statement of profit or loss and other comprehensive income.

Discontinuation

The new model restricts the ability to discontinue hedge accounting to situations where the qualifying criteria are no longer being met (e.g. the hedged item or hedging instrument no longer exists or is sold, or the hedged objective has changed). Voluntary discontinuation is **not** permitted. Where part of a forecast transaction is no longer highly probable, the new requirement allows you to discontinue for the volume of the hedged item that is no longer highly probable. For example, Entity A takes out a hedge to hedge the price for the sale of 10,000oz of gold in six months time. However, three months into the hedge, due to unforseen circumstances, (e.g. delay in production due to rain) Entity A is now only expecting to produce 6,000oz of gold. Under the new requirements, Entity A is permitted to discontinue hedging for the 4,000oz of gold and continue hedging the 6,000oz of gold without having to redesignate the hedging relationship.

Disclosures

New disclosure requirements accompany the new model and have been added to IFRS 7 *Financial Instruments: Disclosures*. The disclosures are only required for exposures to which hedge accounting is being applied. The new model requires disclosure, by risk category, of:

- The description of the risk management strategy
- Information about the notional amount, timing of the cash flows, and the average price or rate of the hedging instrument
- The effect that hedge accounting has had on the financial statements.

Transition

The new requirements would apply prospectively. The exception is for the time value of options, forward points and foreign currency basis spread, where retrospective application applies.

What you should do?

If you plan to take out derivatives as an economic hedge of your risk positions, you should consider the new requirements carefully and assess whether you qualify for hedge accounting under IFRS 9. Although applying hedge accounting is likely to reduce profit or loss volatility for your entity, you would also need to consider the impact of adopting the classification and measurement requirements of IFRS 9 because hedge accounting cannot be adopted in isolation. A holistic assessment needs to be made of IFRS 9 as to whether the pros of early adoption exceed the cons for your entity.

For any existing economic hedge positions that you currently do not hedge account, there may still be benefits from applying the new requirements, for example, less profit or loss volatility from hedging risk components of non-financial items and aggregated positions, and using options and forwards as hedging instruments. Because most of the requirements apply prospectively, some degree of 'artificial' profit or loss volatility may still arise.

If your entity already applies hedge accounting, there may still be some benefits from applying the new requirements, for example, less onerous effectiveness testing and less profit or loss volatility from using options and forwards. Because most of the requirements apply prospectively, some degree of 'artificial' profit or loss volatility may still arise. However, the new requirements for options and forwards apply retrospectively. Therefore if you currently take out options or forwards, and have designated the intrinsic value or the spot element as the hedging instrument, all movements in the time value of money of your options, or the forward points of your forwards, can be recognised in OCI under the new requirements without having to start a new hedging relationship.

Can we early adopt IFRS 9 and the revised hedging requirements in Australia?

Australian financial statements prepared under Chapter 2M of the *Corporations Act 2001* must comply with Australian Accounting Standards. Despite Australian Accounting Standards being IFRS compliant, new and amending international accounting standards need to be approved by the Australian Accounting Standards Board (AASB) before they form part of Australian Accounting Standards. As such, these amendments cannot be adopted early in Australia until they have been approved by the AASB. However, we understand that the AASB will try and expedite this process as soon as possible.

If you would like more information on IFRS 9 and the revised hedging requirements, please contact Judith Leung. Judith was formerly a staff member at the IASB and was part of the team that developed this new model, and is therefore ideally placed to assist companies in reducing the volatility of their financial results that derivatives can cause.

WHAT'S NEW FOR DECEMBER 2013 FINANCIAL REPORTS?

FOR PREPARERS OF FINANCIAL STATEMENTS FOR ANNUAL AND HALF-YEAR PERIODS ENDING 31 DECEMBER 2013, 2013 IS TURNING INTO ANOTHER 'BIG BANG' OF NEW AND AMENDING STANDARDS AND INTERPRETATIONS, NOT SEEN SINCE 2005, AND TO A LESSER EXTENT, IN 2009.

1 January 2013 is the start date for many new standards and interpretations which may impact your 31 December 2013 annual or half-year financial statements, including:

- AASB 10 *Consolidated Financial Statements*
- AASB 11 *Joint Arrangements*
- AASB 12 *Disclosure of Interests in Other Entities*
- AASB 13 *Fair Value Measurement*
- AASB 119 *Employee Benefits*
- Interpretation 20 *Stripping Costs in the Production Phase of a Surface Mine.*

Additionally, AASB 2011-9 *Amendments to Australian Accounting Standards - Presentation of Items of Other Comprehensive Income* is effective for periods starting on or after 1 July 2012, so will impact your 31 December 2013 annual financial statements for the first time. Note that for entities preparing half-year financial statements at 31 December 2013 (with 30 June year ends) this standard will already have impacted you at 30 June 2013.

We have included a brief summary of the changes in each of these standards and interpretations.

AASB 10 *Consolidated Financial Statements*

AASB 10 *Consolidated Financial Statements*, which includes the new consolidation requirements, replaces AASB 127 *Consolidated and Separate Financial Statements* and Interpretation 112 *Consolidation – Special Purpose Entities.* AASB 10 includes a new definition of 'control' so you may find that you did not previously consolidate some entities which you will now need to consolidate, and in some cases, you may have previously consolidated an entity that you will no longer consolidate under AASB 10. The revised 'control' definition is meant to encompass control principles for entities in which you have a financial interest, as well as structured entities (special purpose vehicles).

In order for an entity (investor) to control an investee, it must have:

- Power over the investee (whether or not that power is used in practice)
- Exposure, or rights, to variable returns from the investee
- The ability to use power over the investee to affect the investor's returns from the investee.

If your group has no non-controlling interests (i.e. all entities are 100% owned and no structured entities), it is probable that nothing will change. However, you need to assess whether any consolidation decisions have changed because of the following:

- De facto control (a sizeable shareholding with remaining shareholders widely dispersed) will mean that you may need to consolidate additional subsidiaries where you own 40-50% of an investment that you previously equity accounted
- Potential voting rights must be substantive to be taken into account when you assess whether you have control (e.g. options that are deeply out-of-the-money are not substantive and are therefore ignored)
- Who controls the 'relevant activity'? If you do not control the relevant activity, you cannot consolidate
- Whether minority rights (or joint venture partner rights) are protective or substantive. If they are substantive, this will prevent consolidation
- Principals will consolidate but agents will not (see extensive guidance in AASB 10)
- New rules on controlling the 'relevant activity' may lead to classifying joint ventures as either subsidiaries (if you control the relevant activity) or associates if you only have protective rights.

Besides providing principles for determining control, AASB 10 also includes the mechanics for how to prepare a consolidation, leaving the superseded version of AASB 127, called AASB 127 *Separate Financial Statements,* to deal with disclosure and measurement requirements for subsidiaries, joint ventures and associates in separate financial statements. These are unchanged, and still permit a choice of cost or fair value under AASB 139 *Financial Instruments: Recognition and Measurement*.

For more information refer to article in our May 2013 Accounting News - Will the new consolidations and joint arrangements standards change your financial statements?

AASB 11 *Joint Arrangements*

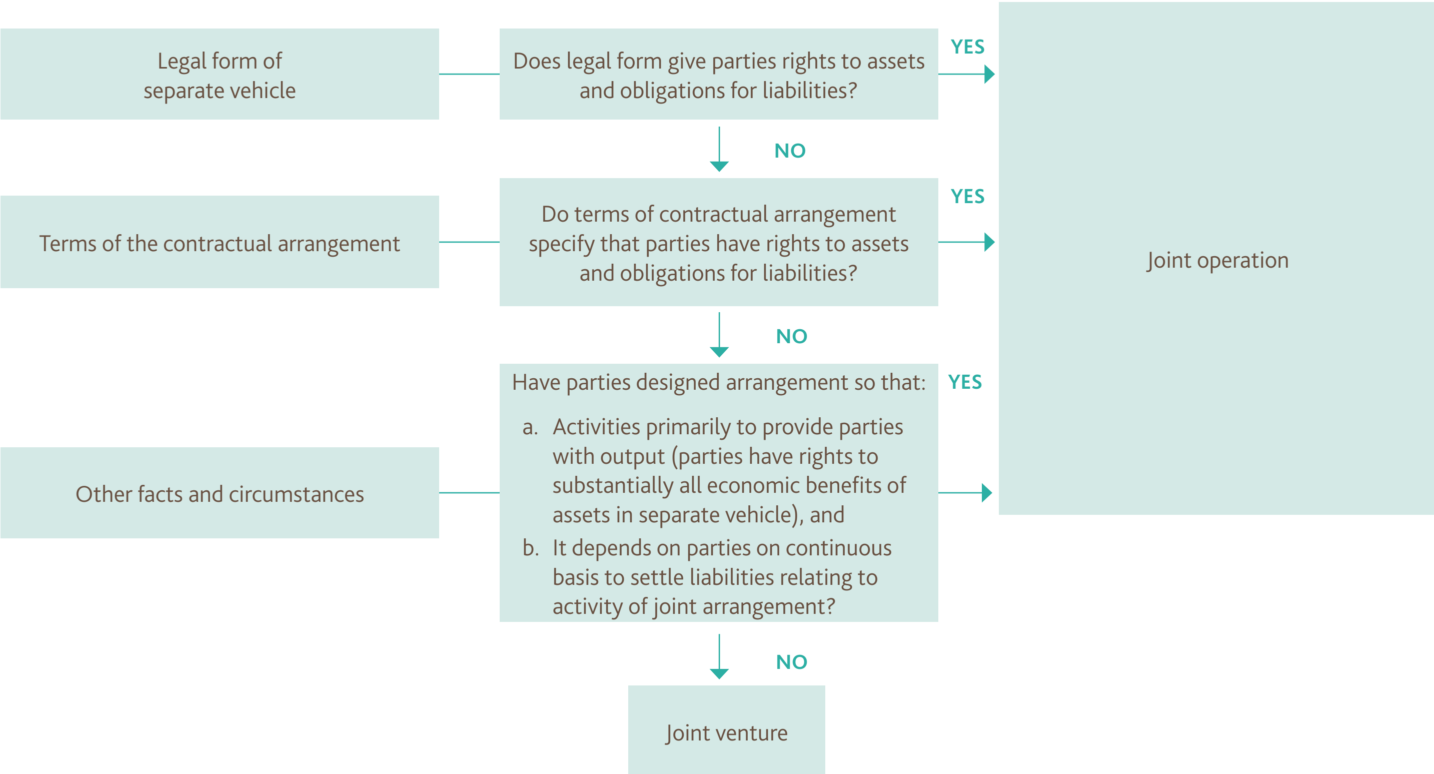
The new concept of 'control' contained in AASB 10 extends into the application of accounting for joint arrangements. If two or more parties jointly control the relevant activities of an investee then you are within the scope of AASB 11. However, if one party controls the relevant activity then you are within the scope of AASB 10. If there is a combination of parties that can control the relevant activity then you are not in the scope of AASB 11.

There are now only two types of joint arrangements:

- **Joint operations** – where parties with joint control have rights to assets and obligations for the liabilities of the arrangement
- **Joint ventures** – where parties with joint control of an entity with legal substance have rights to the net assets of the arrangement.

Parties to a joint operation would account for assets and liabilities according to their rights and obligations to the arrangement. Joint ventures must be accounted for using equity accounting. The proportionate consolidation method is no longer permitted for joint ventures.

The following flowchart summarises how you decide whether your joint arrangement should be classified as a joint operation or a joint venture.



So when applying AASB 11 for the first time, you will need to:

1. Decide what the relevant activities of the arrangement are
2. Read the governing agreements carefully to decide whether one or more parties have joint control over these relevant activities, i.e. unanimous consent must be required for all decisions about the relevant activities
3. Once joint control has been established, assess whether the arrangement is conducted through a separate vehicle
4. If not conducted through a separate vehicle you have a joint operation and must account for your share of assets, liabilities, revenues and expenses of the joint operation
5. If conducted through a separate vehicle – say a company – usually you will have a joint venture. Otherwise, you could have a joint operation if the terms of the arrangement override the normal 'corporate veil' of a company, or the facts and circumstances indicate that, in substance, the parties to the joint arrangement are obtaining substantially all of the economic benefits of the arrangement and are therefore liable for the debts of the arrangement (because the vehicle will depend on the parties to settle the liabilities on a continuous basis). This may occur, for example, if a vehicle is setup to produce raw materials for Joint Venturer A and Joint Venturer B, at a break even, and which is not allowed to sell its output to anyone else.

Note that the assessment of the legal rights to assets and obligations for liabilities of separate vehicles, other than for companies, is not a simple procedure. Most often, you will need to seek legal advice in order to conclude on the classification of your arrangement as a joint operation or a joint venture. This is because laws may be different from state to state and also for different types of vehicles, e.g. partnerships and trusts.

For more information refer to article in our May 2013 Accounting News - Will the new consolidations and joint arrangements standards change your financial statements?

AASB 12 *Disclosure of Interests in Other Entities*

To round off the new consolidation and joint venture requirements, AASB 12 requires considerably more disclosure than what you have previously provided in your financial statements.

Some new disclosures include:

- Significant judgements regarding why entities have/have not been consolidated, whether acting as principal or agent and why classified as a joint venture or a joint operation where judgement involved
- Extensive information about subsidiaries with non-controlling interests
- More detailed financial information on joint ventures
- Unconsolidated structured entities
- Extensive disclosures on restrictions to access funds and assets held in subsidiaries
- Commitments to support subsidiaries and joint ventures.

We recommend that you redesign your disclosure templates as soon as possible to incorporate these extra disclosures.

AASB 13 *Fair value Measurement*

What appeared to initially be a fairly benign standard whose major implication meant disclosure, disclosure, and more disclosure about fair values (both measured and disclosed in financial statements), may have some hidden consequences for some entities because the definition of 'fair value' has been changed from being a neutral value to now being an 'exit price'.

We therefore recommend that you carefully scrutinise all fair value measures used in your 31 December financial statements (both recognised and merely disclosed) to ensure that your previous methodologies are compliant with the AASB 13 'exit price'. In this regard, you need to ensure that:

1. You use an 'exit price', i.e. price received to sell an asset or to transfer a liability
2. The price represents an orderly transaction and not a forced sale
3. The price is measured using assumptions that market participants would use
4. You need to use the price in the principal market, or the most advantageous market (market where you could get the best price) – the most advantageous market is only used if there is no principal market

5. Transport costs are only taken into account when determining fair value if location is a characteristic of the asset i.e. need to incur transport costs to get the asset to market
6. For **non-financial assets**, fair value is based on current use, unless market or other factors suggest that 'highest and best use' would maximise the fair value, in which case 'highest and best use' will be used
7. You do not adjust for blockage factors (e.g. large holdings or control premiums) when determining fair value if the unit of account is an individual asset
8. Derivative valuations reflect your own credit risk for your derivative liabilities and the bank's credit risk for your derivative assets (Usually valuations provided by the banks are based on a risk free rate, without adjustments, for your own credit risk or the bank's credit risk).

We also recommend that you redesign your disclosure templates as soon as possible because extensive adjustments will need to be made, particularly with respect to Level 1, Level 2 and Level 3 disclosures now being required for **all assets**, and extensive disclosures required for Level 3 fair values such as owner-occupied land and buildings, and investment property.

Note for half-years – Fair value disclosures for financial instruments

Generally, half-year financial statements prepared under AASB 134 *Interim Financial Reporting* are considerably condensed and unaffected by extensive disclosures required for annual financial statements. However, please note that your 31 December 2013 **half-year** financial statement template needs to include most of the annual fair value disclosures about financial instruments. Refer AASB 134, paragraph 16A(j).

AASB 119 *Employee Benefits*

The 'corridor approach' for deferring gains/losses on defined benefit plans is no longer permitted. All actuarial gains/losses will be recognised in other comprehensive income and will not be permitted to be reclassified to profit or loss in a future period.

Liabilities for employee benefits will be calculated based on date of expected settlement, rather than the date when settlement is due. This may result in liabilities, for example annual leave, being discounted where the entity does not expect that all employees will take their annual leave wholly within twelve months after the end of the reporting period. That is, annual leave is measured as a long-term benefit, resulting in potentially lower annual leave liabilities where pay rises and promotions were factored into the previously undiscounted annual leave liability. However, annual leave would still be presented as a current liability under AASB 101 *Presentation of Financial Statements*.

Interpretation 20 *Stripping Costs in the Production Phase of a Surface Mine*

This interpretation will likely only impact deep, opencast mining operations. It does not apply to preproduction stripping, or underground activity. Stripping activity which provides benefit in the form of inventory produced will be accounted for in accordance with the principles of AASB 102 *Inventories*.

The interpretation requires a detailed analysis as to which ore body has been 'enhanced' as a result of the stripping activity. The enhanced ore body is likely to be significantly smaller than the ore body/area of interest that most mine costs are being recouped over using the unit of production method.

If the benefit of the production stripping is improved access to ore, you must recognise these costs as a non-current asset if certain criteria are met ('stripping activity asset') and account for it for as an addition to, or as an enhancement of, an existing asset. You will then depreciate/amortise this stripping activity asset over the expected useful life of the identified component of the ore body that becomes more accessible (enhanced) as a result of the stripping activity.

AASB 2011-9 *Amendments to Australian Accounting Standards – Presentation of Items of Other Comprehensive Income*

This amending standard introduces name changes to the 'statement of comprehensive income'. If you present one statement of comprehensive income, it will be referred to as the **'statement of profit or loss and other comprehensive income'**. If you present two statements:

- The income statement will be referred to as the 'statement of profit or loss'
- The name for the statement of comprehensive income will not change.

Irrespective of whether one or two statements are presented, the amendments clarify that the profit or loss section/statement must appear first.

The changes also require other comprehensive income (OCI) to be split into two sections, showing separately:

- Items that will be reclassified to profit or loss in future (e.g. cash flow hedge reserves, foreign currency translation reserves, available-for-sale reserves, etc.)
- Items that cannot be reclassified to profit or loss in future (e.g. property, plant and equipment revaluation reserves).

If presenting OCI items gross of income tax, the income tax effect of items that will be reclassified to profit or loss in future, and those that will not, must be shown in their respective OCI sections.

For more information

For more information on new or amending standards for 31 December 2013, refer to our recent Financial Reporting Standards Update.

ASIC ISSUES GUIDANCE TO DIRECTORS ON FINANCIAL REPORTING RESPONSIBILITIES

IN LIGHT OF THE FINDINGS IN THE CENTRO CASE ABOUT DIRECTORS' FINANCIAL REPORTING RESPONSIBILITIES, ASIC RECENTLY ISSUED INFORMATION SHEET 183 *DIRECTORS AND FINANCIAL REPORTING* (INFO 183) WHICH EXPLAINS DIRECTORS' FINANCIAL REPORTING RESPONSIBILITIES, INCLUDING GENERAL DUTIES, THE COMPANY'S DUTY TO KEEP PROPER BOOKS AND RECORDS, WHAT DIRECTORS SHOULD CONSIDER WHEN PREPARING A FINANCIAL REPORT, THEIR FINANCIAL LITERACY OBLIGATIONS AND THEIR RELATIONSHIP WITH THE AUDITOR.

Interestingly, INFO 183 focusses on **all directors** having financial reporting responsibilities, not just a CA qualified director, or members of the audit committee.

Duty to keep records

INFO 183 reminds directors that the company must keep written financial records that:

- Correctly record and explain the company's transactions and its financial position and performance
- Enable true and fair financial statements to be prepared and audited.

In this regard, INFO 183 also reminds directors that they need to ensure that their company's records are complete and accurate by:

- Adopting appropriate accounting policies
- Designing and implementing appropriate controls and processes.

These obligations exist regardless of whether books and records are maintained in-house or outsourced to a third party, or whether they are electronic or hard copy records.

For more information, INFO 183 refers you to Information Sheet 76 *What books and records should my company keep?* (INFO 76).

Directors' financial reporting obligations

Companies must lodge financial reports with ASIC and the reports must include a directors' declaration that includes:

- Whether, in the directors' opinion, there are reasonable grounds to believe that the company will be able to pay its debts as and when they become due
- Whether the financial statements and notes comply with accounting standards, and give a true and fair view of the financial position and performance of the company and any consolidated entity
- If the company is listed, whether the directors have been given the declarations required by the chief executive officer (CEO) and chief financial officer (CFO).

In order to make this declaration, directors need to ensure that they have read, understood and focussed on the contents of the financial report.

"You must apply your own mind to, and carry out a careful review of, the financial report and directors' report, determine that the information they contain is consistent with your knowledge of the company's financial position and affairs, and ensure that material matters known to you, or that should be known to you, are not omitted."

ASIC expects that when directors read the financial report, they should:

- Ensure, as far as possible and reasonable, that the information included is accurate
- Question the accounting treatments applied
- Examine the adequacy of disclosures and whether there are any matters that have been omitted which should be disclosed
- Enquire further into the matters revealed by the financial report.

Using external advice and information

INFO 183 acknowledges that directors can delegate others to prepare the books and records and the financial report, but they are expected to take a diligent and intelligent interest in the information available to them, to understand that information, and apply an enquiring mind.

ASIC expects that when directors make enquiries, they may request management to obtain professional accounting advice on appropriate accounting treatments from suitably qualified accountants with the appropriate level of expertise and knowledge of the accounting standards, and that such advice is unbiased and objective.

Directors should also read and focus on the content of any market announcements of results, presentations to investors or briefings to analysts.

Audit committees

INFO 183 recognises that audit committees play an important role in ensuring financial reporting and audit quality but the existence of an audit committee does not diminish other directors' responsibility in relation to the company's financial report.

CEO and CFO declarations

INFO 183 stresses that if the company is listed, the CEO and CFO declarations do not reduce the responsibility of a director to ensure that the financial report complies with Chapter 2M of the *Corporations Act 2001*.

Directors still need to ensure that the CEO and CFO have sufficient qualifications, knowledge, competence, experience and integrity to undertake their roles.

Your financial literacy

INFO 183 also stresses the importance of directors having financial literacy:

- Directors need to have sufficient knowledge of accounting principles and practices
- Directors need to ensure that they are appropriately educated and keep up to date on the current accounting standards and financial reporting requirements of the *Corporations Act 2001*, particularly where these may impact accounting policies and the financial report
- Directors must understand their company's business and have an appropriate level of financial literacy so that they can ensure that transactions and events have been reflected in the financial report
- Even if directors are not accounting experts, they must challenge the accounting treatments applied in the financial report, seek explanations and seek appropriate professional advice supporting the accounting treatments chosen. Particularly where the treatment does not reflect their understanding of the substance of an arrangement (e.g. financial instruments classified as equity where the intent is to borrow)
- Even though impairment models or valuation models can be complex, directors should still be able to review the cash flows and assumptions used, bearing in mind their knowledge of the business, the assets and the future prospects of the business.

Directors' relationship with the auditor

While the external auditor provides an independent opinion on the financial report, directors are responsible for the financial report and cannot rely on the external auditor in forming their own opinion on the financial report.

Resources

INFO 183 provides the following links to financial literacy resources that directors may find useful but ASIC do not endorse any of these courses, publications or resources:

- The Australian Institute of Company Directors
- CPA Australia (see 'Financial literacy' section on right-hand side of page)
- The Institute of Chartered Accountants in Australia.

INFO 183 also refers to the following:

- *Corporations Act 2001* - Sections 180(1), 286(1), 295, 295A, 296(1), 297, 298(1AA), 300(11A), 300(11B), 300(11C), 312 and 331
- Regulatory Guide 22 Directors' statement as to solvency (RG 22) for guidance on the solvency declaration
- Information Sheet 76 *What books and records should my company keep?* (INFO 76)
- *Australian Securities and Investments Commission v Healey* [2011] FCA 717.

For more information for non-executive directors, refer to our Non-executive directors: Questions you need to ask publication.

NEW BDO PUBLICATIONS

The Audit section of our website includes a range of publications on IFRS issues. Look for the 'Global IFRS Resources' link which includes resources such as:

IFRS at a Glance – 'one page' and short summaries of all IFRS standards.

IFRS News at a glance – provides high-level headlines of newly released documents by the IASB and IFRS related announcements by securities regulators

Need to Knows – updates on major IASB projects and highlights practical implications of forthcoming changes to accounting standards. Recent Need to Knows include Leases

IFRS in Practice – practical information about the application of key aspects of IFRS, including industry specific guidance

Comment letters on IFRS standard setting – includes BDO comments on various projects of international standard setters, including Exposure Drafts and other Discussion Papers, when it is considered that the issue is significant to the BDO network and its clients. Latest comment letters include IAS 2013-8 *Agriculture-Bearer Plants*, IASB 2013-6 *Leases*, IASB ED 2013-5 *Regulatory Deferral Accounts* and IASB ED 2013-3 *Financial Instruments: Expected Credit Losses*

CHARITIES HAVE MORE TIME TO LODGE THEIR ANNUAL INFORMATION STATEMENTS

The Australian Charities and Not-for-profits Commissioner, Susan Pascoe, announced in her Commissioner's Column on 26 November 2013 that charities with a 1 July to 30 June financial reporting period will have **until 31 March 2014** to lodge their first annual information statement (AIS) for the year ended 30 June 2013. The AIS was originally required to be lodged on 31 December 2013.

The reason for the extension is that this is the first time many charities have needed to report to the Australian Charities and Not-for-profits Commission (ACNC), and there may be some charities that are not aware of their obligations. The ACNC Act does not allow the Commissioner to delay the issuing of administrative penalties for late lodgement, therefore the extension of time means those entities lodging before 31 March 2014 will not receive a penalty.

Charities are still encouraged to meet the 31 December 2013 deadline if possible, because the information provided will be used to populate the 2014 AIS and provide the community with up-to-date details on your charity.

COMMENTS SOUGHT ON EXPOSURE DRAFTS

At BDO, we provide comments locally to the Australian Accounting Standards Board (AASB) and internationally to the International Accounting Standards Board (IASB). We welcome any client comments on exposure drafts that are currently available for comment. If you would like to provide any comments please contact Wayne Basford at wayne.basford@bdo.com.au.

DOCUMENT	PROPOSALS	COMMENTS DUE TO AASB BY	COMMENTS DUE TO IASB BY
ITC29A *A Review of the IASB's Conceptual Framework for Financial Reporting*	Proposes an improved *Conceptual Framework* to replace the IASB's existing *Conceptual Framework*.	8 November 2013	14 January 2014
ED 246 *Equity Method in Separate Financial Statements (proposed amendments to AASB 127)*	Proposes to reintroduce an option into AASB 127 *Separate Financial Statements* to enable entities preparing separate financial statements to use equity accounting to account for investments in subsidiaries, associates and joint ventures, instead of using cost or fair value as currently permitted by AASB 127.	24 January 2014	3 February 2014

FOR MORE INFORMATION

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