IFRS 10 and 11: Retrospective Transition Issues

Extract, IFRS Discussion Group Report on Meeting – October 18, 2012

The transition guidance in IFRS 10 *Consolidated Financial Statements* requires full retrospective application of the standard from the date that control was first obtained, with some limited exceptions. The transitional guidance in IFRS 11 *Joint Arrangements* requires a modified retrospective application and specifically addresses the transition mechanics to be applied when:

- a proportionately consolidated entity will be accounted for by the equity method under IFRS 11; and
- a joint operation accounted for by the equity method will be accounted for by recognizing the investor's interest in the assets and liabilities of the joint operation.

IFRS 11 does not provide any explicit transition guidance when an entity proportionately consolidated a joint operation previously and will account for its interest in the assets and liabilities of the joint operation upon adoption of the new standard.

An investment will often have been made before the periods covered by the financial statements issued in the year IFRS 10 and IFRS 11 are first applied. Some significant implications arise from the retrospective application of IFRS 10 and, to a lesser degree, IFRS 11 when the prior basis of accounting for an investee (portfolio investment, associate, joint venture or subsidiary) is changed upon the adoption of IFRS 10 and IFRS 11. For example, a change in basis would occur when an investee that was not consolidated previously needs to be consolidated under IFRS 10.

When retrospective application is required by IFRS 10 or IFRS 11 and the basis of accounting for the investee changes, the entire suite of IFRSs would also have to be applied to the investee retrospectively from the date determined by the transition guidance in order to determine the appropriate carrying amount of the assets and liabilities of, or investment in, the investee, with limited exceptions.

For example, when the investee that is now being consolidated on adoption of IFRS 10 has property plant and equipment recognized in its statement of financial position, the transition guidance requires that the carrying amount of the property, plant and equipment on the date that control was first obtained be determined in accordance with IFRS 3. To determine the carrying amount of the investee's property plant and equipment at the beginning of the comparative period, the investor must consider the recognition and measurement requirements of all standards that affect property, plant and equipment including, but not necessarily limited to, IAS 16 *Property, Plant and Equipment*, IAS 23 *Borrowing Costs*, IAS 36 *Impairment of Assets* and IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* (for example, for asset retirement obligations).

The four most common transition scenarios expected to occur in the Canadian marketplace are:

- a change from non-consolidation to consolidation upon adoption of IFRS 10;
- deconsolidation of a subsidiary upon adoption of IFRS 10;

- a change from the equity method of accounting to accounting for a share of assets and liabilities of a joint operation upon adoption of IFRS 11; and
- a change from proportionate consolidation to the equity method for a joint venture upon adoption of IFRS 11 (considered in the separate agenda item "IFRS 11: Joint Ventures – Transition from Proportionate Consolidation to the Equity Method").

The Group considered some of the general and standard-specific implementation challenges that financial statement preparers may experience when applying certain IFRSs on a retrospective or modified retrospective basis upon a change in the basis of accounting for the investee upon adoption of IFRS 10 or IFRS 11.

The Group's Discussion

Although not an exhaustive list, Group members discussed the following four IFRSs that may be most likely to give rise to complex issues:

IAS 21 *The Effects of Changes in Foreign Exchange Rates*;

IAS 23 *Borrowing Costs*;

IAS 36 *Impairment of Assets*; and

IFRS 3 *Business Combinations*.

In the context of IAS 21, Group members observed that when an investee was not consolidated or accounted for by the equity method previously, the investee's functional currency would not have been determined previously. Group members noted that when the functional currency of an investee differs from that of the investor, the transitional requirements of IFRS 10 require that IAS 21 be applied retrospectively to determine the cumulative translation differences to be recognized by the investor. In addition, the functional currency determination will be relevant in determining the amounts to recognize for foreign currency monetary and non-monetary balances when consolidation is applied for the first time. Group members observed that complexities arise in determining the cumulative translation differences balance because the investee's net assets must be determined at each past reporting date and the appropriate exchange rate applied to each of those amounts.

Group members noted that those issues become more troublesome when considering how the exemptions and elections under IFRS 1 *First-time Adoption of International Financial Reporting Standards* utilized on transition to IFRSs interact with the transitional requirements of IFRS 10 and IFRS 11 for periods prior to the date of transition. Group members observed that applying IFRS 10 and IFRS 11 on a retrospective or modified retrospective basis when changing the basis of accounting for the investee can be similar to the initial application of IFRSs, but without any of the relief provided by the IFRS 1 elections or exemptions. Group members cautioned that this is an area of judgment. Careful consideration should be given to whether the effect of the IFRS 1 exemptions and elections applied by the investor upon adoption of IFRSs may be applied to any balances recognized as a result of adopting IFRS 10 and IFRS 11. For example, if an entity chose to set its cumulative translation account to zero on adoption of IFRSs, it would need to consider whether to create a balance as a result of retrospectively applying IFRS 10 or IFRS 11.

Group members observed that a similar issue arises when considering how IAS 23 applies on transition to IFRS 10 and IFRS 11. Group members discussed the potential complexity in determining the amount of borrowing costs that should be capitalized to qualifying assets. Group members noted that obtaining the data to perform this work, such as the amount and timing of expenditures and the capitalization rate, will not be a small task.

Similarly, Group members discussed whether adjustments to the carrying amount of the investee's assets within the scope of IAS 36, including goodwill, are required to reflect additional impairment charges or to reverse previously recorded impairment charges. When the investor is required to apply IAS 36 retrospectively to any assets in the investee's statement of financial position that are within the scope of that standard, the investor will have to determine how to do so. Group members observed that the transition guidance in IFRS 10 does not address this issue. Group members noted that the IAS 36 implications are particularly troublesome because of the potential use of hindsight. In many cases, goodwill was only tested as at the date of transition to IFRSs and not earlier and, accordingly, cash-generating units may not have been determined for those earlier periods. Some Group members noted that the analysis might expose weaknesses in how cash-generating units were previously determined. Group members expressed concern over how to deal with this issue on transition and determine the necessary disclosures about any adjustments required.

Finally, when considering IFRS 3, Group members discussed the transitional requirements when an investee is required to be consolidated for the first time upon adoption of IFRS10 and the investee does not meet the IFRS 3 definition of a business. The Group considered whether certain specialized accounting requirements within IFRS 3, which generally relate only to the acquisition of a business, are required to be applied when a non-business investee is first consolidated upon adoption of IFRS 10. Those specialized accounting requirements include accounting for contingent consideration, transaction costs and deferred income taxes. Group members noted that this issue arises because IFRS 10 requires the use of the "acquisition method" in IFRS 3 to recognize assets, liabilities and non-controlling interests initially, except for goodwill, and the term "acquisition method" is not clearly defined in IFRS 3.

Overall Comments

The Group noted that many of the standard-specific implementation challenges arise upon transition to IFRS 10 and IFRS 11 when the investee's past financial statements were not prepared in accordance with IFRSs. Group members observed that the list of standards discussed is not exhaustive. For example, there will likely be many tax accounting issues that will be challenging in applying the transition requirements in IFRS 10 and IFRS 11.

The Group agreed that because IFRS 10 and IFRS 11 will be applied first by calendar year companies in the first quarter of 2013, it is not possible to seek resolution from the International Accounting Standards Board (IASB) or IFRS Interpretations Committee (IFRIC) before Canadian companies need to file first quarter interim financial statements.

Group members emphasized that preparers need to think broadly about the repercussions of the retrospective application of IFRS 10 and IFRS 11. Group members noted that given the complexity that some issuers may face in applying these standards retrospectively, preparers need to start work now and consult with their advisers to navigate the complexities that arise when a change of basis occurs upon adoption of IFRS 10 and IFRS 11. Group members noted that judgment will be required and early consideration of all the circumstances, including the interaction with IFRS 1 elections and exemptions, will be required for a successful implementation of these new standards.