

FRS News

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Welcome to FRS News - An update from **SJ Grant Thornton**. FRS News offers a summary of the more significant developments in Financial Reporting Standards (FRS) along with insights into topical issues and views from **SJ Grant Thornton**.

Contents

- **FRS 3 'Business Combinations'** introduces significant changes to business combinations accounting; effective for business combinations occurring in annual periods beginning on or after 1 July 2010.
- treatment of transactions with non-controlling interests and the amended **FRS 127 'Consolidated and Separate Financial Statements'**.
- new guidance on accounting for cash-settled awards in group situations in the amended **FRS 2 'Share-based Payment'**.
- main amendments to **FRS 7 'Financial Instruments: Disclosures'** whereby the additional compliance challenges is discussed for disclosure requirements in relation to the determination of fair value of financial instruments and liquidity risk.
- **FRS 136 'Impairment of Assets'**, highlighting the impairment testing process and its related disclosures.
- **FRS 8 'Operating Segments'**, notably in identification of information reported to the Chief Operating Decision Maker of reporting entities.



Business Combinations

FRS 3 revised
The revised FRS 3 'Business Combinations' was effective for business combinations occurring in annual periods beginning on or after 1 July 2010.

FRS 3 (Revised) introduced significant changes to business combinations accounting, thereby creating potential pitfalls for the unwary.

Transaction costs

One key change brought in by FRS 3 (Revised) is that directly attributable transaction costs are required to be expensed as incurred in the consolidated accounts. Previously these were capitalised as part of the cost of the business combination and were therefore included in goodwill. Examples of such costs include legal and accountancy fees. Under FRS 3 (Revised), consideration transferred only includes amounts paid to the vendor to obtain control of the acquiree, and therefore excludes these costs.

Contingent consideration

It is common for acquisition arrangements to include an amount of consideration for which payment is contingent on the occurrence of a future event, or where the amount to be paid in the future varies dependent on, for example, the level of future profits of the acquiree. FRS 3 (Revised) has changed significantly the accounting for such contingent consideration.

Where there is contingent consideration in a business combination, under FRS 3 (Revised) this is included at fair value in the consideration transferred at the acquisition date. Where contingent consideration gives rise to a financial liability, subsequent changes to fair value will be recognised in profit or

loss, potentially leading to statement of comprehensive income volatility. Where contingent consideration meets the definition of equity under FRS 132 'Financial Instruments: Presentation', there is no subsequent remeasurement.

Acquisitions achieved in stages

FRS 3 (Revised) contains specific guidance on the accounting for a business combination where the acquirer previously had an equity interest in the acquiree, whether that equity interest was accounted for as an investment, an associate or a joint venture. Acquisition accounting is applied only at the date that control is obtained. This means, for example, that the purchase of a non-controlling interest in an existing subsidiary is not in the scope of FRS 3 (Revised); instead such transactions are accounted for under FRS 127 'Consolidated Financial Statements'.

At the date that control is achieved, any previously held equity interest in the acquiree is treated as if it were disposed of and reacquired at fair value. Any changes in value of the equity interest that were previously recognised in other comprehensive income are reclassified from equity to profit or loss, consistent with the treatment on a disposal. The fair value of the previously held equity interest is included in the calculation of goodwill, as the disposal of this at fair value is effectively treated as part of the

consideration in the acquisition.

Intangible assets acquired

Recognition of intangible assets

A further difference is that in developing FRS 3 (Revised) the International Accounting Standard Board concluded that all intangible assets acquired as part of a business combination should be capable of reliable measurement. This is expected to lead to more intangible assets being recognised than under the previous version of FRS 3, where there was not the same presumption that intangible assets should be capable of reliable measurement.

Consistency with management commentary

Where a business combination is discussed by management in their narrative reporting, this may cover expected benefits of the acquisition such as the use of brand names or access to customer relationships. This should be consistent with the identification of intangible assets acquired in the notes to the financial statements. Regulators have advised management to consider carefully the consistency between the accounting for business combinations and their narrative reporting and public announcements.

Disclosure by class of assets

The disclosure requirements of FRS 3 (Revised) are extensive and

include the amounts recognised at the acquisition date for each major class of assets acquired. Regulators have challenged companies that have aggregated intangible assets into a single class when it has appeared from other information presented about an acquisition that there was in fact more than one class of intangible assets. Different classes of intangible assets might include, for example, brand names, customer contracts, patent rights and software.

Other changes

Indemnification assets

In an acquisition agreement, the seller may agree to indemnify the acquirer against a future uncertain liability, such as a warranty claim. FRS 3 (Revised) specifies that in this situation the acquirer recognises the liability, as it is an identifiable liability of the acquirer at the acquisition date, and also recognises an indemnification asset, which is measured on the same basis as the indemnified liability.

Settlement of pre-existing relationships

Where there is a pre-existing relationship between the acquirer and acquiree and this is settled as part of the business combination, FRS 3 (Revised) requires that any amount paid to settle the relationship is excluded from the consideration transferred. This amount is not considered to have been paid to gain control of the acquiree, and

is therefore not part of the business combination. Pre-existing relationships may be contractual, such as a licence agreement, or non-contractual, for example a lawsuit.

Re-acquired rights

The acquirer may have previously granted a right, for example, in a franchise agreement, to the acquiree. Where this is the case, FRS 3 (Revised) states that the re-acquired right is recognised as an intangible asset on acquisition, and is amortised over its remaining life.



Consolidated Financial Statements

Amended FRS 127

The amended FRS 127 'Consolidated and Separate Financial Statements' is effective for annual periods beginning on or after 1 July 2010.

Transactions with non-controlling interests

Non-controlling interests were known in the previous version of FRS 127 as minority interests. In the amended FRS 127, non-controlling interests are considered to be part of equity. The effect of this is that transactions between non-controlling interests and the parent which do not affect control are considered to be movements in equity. This means that:

- no profit or loss is recognised when the parent sells part of its equity interest but does not lose control
- there is no goodwill recognised on transactions where the parent purchases all or part of the non-controlling interest.

Disposal of a controlling interest

The disposal of a controlling interest in a subsidiary is accounted for under FRS 127. A parent might sell its interest in a subsidiary completely, or retain an equity interest giving significant influence or simply as an investment.

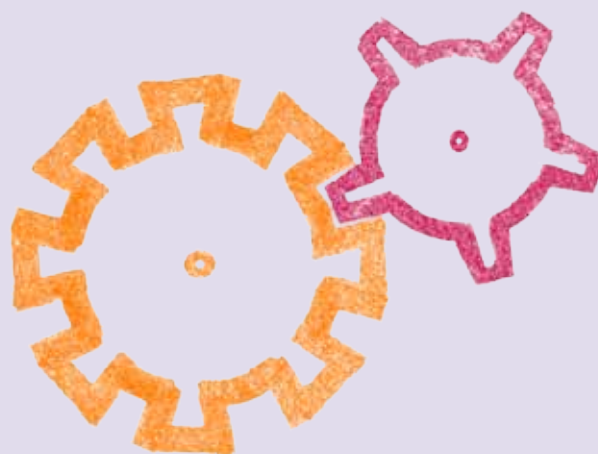
The amended FRS 127 requires that, when a parent loses control of a subsidiary, it derecognises the assets, liabilities and goodwill of the subsidiary, and any non-controlling

interest on the date of disposal. Any amounts previously recognised in other comprehensive income in relation to the subsidiary will generally be reclassified to profit or loss.

Any retained equity interest in the former subsidiary is recognised at its fair value at the date of disposal.

Non-controlling interests in net liabilities

In a change to previous FRS requirements, under the amended FRS 127, where losses attributable to the non-controlling interests exceed the non-controlling interest in the subsidiary's equity, the excess and any further losses continue to be attributed to the non-controlling interests. In such cases, non-controlling interests are shown as a debit balance within equity, separately from equity attributable to the parent shareholders.



Share-Based Payments

FRS 2 changes: cash-settled awards in groups

FRS 2 'Share-based Payment' has been amended for periods beginning on or after 1 January 2011 to include guidance on accounting for cash-settled awards in group situations. At the same time, FRS 2 has also been amended to incorporate two interpretations: IC Interpretation 8 'Scope of FRS 2' and IC Interpretation 11 'FRS 2 – Group and Treasury Share Transactions'. The incorporation of these IC Interpretations has not changed the accounting treatment, and therefore this section considers only the new guidance on cash-settled awards in groups.

A parent may grant to employees of a subsidiary a cash award which is based on the share price either of the subsidiary or of the parent itself. The amendment to FRS 2 clarifies that such awards are share-based payment transactions, and deals with the accounting in the individual accounts of each company. From the perspective of the group in its consolidated accounts, the award is a straightforward cash-settled share-based payment.

Accounting treatment in the subsidiary

The employees receiving the award work for the subsidiary. Therefore the subsidiary is receiving the services under the share-based payment and,

following the principle of FRS 2, the subsidiary recognises the share-based payment charge in profit or loss.

The subsidiary has no obligation to settle the award, as the award has been granted by the parent and the parent will settle with the employees. As the subsidiary has no obligation, it accounts for the award as equity-settled. This treatment effectively considers the award to be a capital contribution from the parent company to the subsidiary.

Accounting treatment in the parent company

The parent company has the obligation to settle the award in cash with the employees of the subsidiary. Therefore the parent company recognises a liability. The debit entry in the parent company is not specified in the standard. This is typically recognised as an increase in the investment in the subsidiary, which again is consistent with the treatment of the award as a capital contribution to the subsidiary.

Measurement issues

As the subsidiary recognises the award as an equity-settled share-based payment, the share-based payment charge is based on the fair value of the award at the date of grant.

This will give a difference in measurement compared to the parent company, which measures its

obligation as a cash-settled share-based payment, calculating the fair value of the liability at each reporting date.

Financial Instruments Disclosure

FRS 7 'Financial Instruments: Disclosures' sets out extensive disclosure requirements in relation to financial instruments. Financial instrument disclosures are often highly significant to users of the financial statements but, given the continued economic uncertainties, they have an even greater significance at present. The amendments to FRS 7 which is effective on 1 January 2011 were intended to ensure that companies explained more clearly how they determined the fair value of financial instruments and to improve the disclosure of liquidity risk. These changes presented additional compliance challenges in 2011.

Common disclosure issues

Regulators have commented on some common areas where disclosures need to be improved. These include:

- analysis, by class of financial asset, of the age of the financial assets that are past due but not impaired at the reporting date
- maturity analysis for financial liabilities showing the remaining contractual maturities and describing how the company manages inherent liquidity risk
- a sensitivity analysis in respect of each type of market risk to which the company is exposed at the end of the reporting period.

These areas are considered in more detail below. In addition, a number of companies are noted on apply hedge accounting under FRS 139 'Financial Instruments: Recognition and Measurement' but fail to disclose various information supporting aspects of hedge accounting which are required by FRS 7.

Financial assets past due but not impaired

FRS 7 requires an entity to disclose financial assets that are past due but not impaired. 'Past due' means a financial asset where the counterparty has failed to make payment when contractually due. This would, for example, include slow-paying trade receivables. Entities are required to disclose an ageing of financial assets past due at the

reporting date but not impaired. This disclosure is not the same as an analysis of ageing of receivables (which would also include those not past due).

Maturity analysis (financial liabilities)

For the maturity analysis, FRS 7 requires an entity to disclose:

- a maturity analysis for non-derivative financial liabilities that shows the remaining contractual maturities
- a maturity analysis for derivative financial liabilities. The maturity analysis shall include the remaining contractual maturities for those derivative financial liabilities for which contractual maturities are essential for an understanding of the timing of the cash flows
- a description of how the entity manages the liquidity risk inherent in the above two.

Liquidity risk is defined as the risk that an entity will encounter difficulty in meeting obligations associated with financial liabilities that are settled by delivering cash or another financial asset.

The maturity analysis should cover all non-derivative financial liabilities (including trade payables), derivative financial liabilities that are essential to an understanding of the timing of cash flows and items outside the scope of FRS 139 but within the scope of FRS 7 (eg finance leases). The amounts



included in the analysis should be the contracted, undiscounted cash flows. Hence, the figures often will not equal those in the statement of financial position, which will either be fair values or, more commonly, amortised cost. Time periods should be analysed according to the earliest date on which the entity could be required to pay, and set out in time bands appropriate to the entity. For example, annual time bands may not provide sufficient granularity for the information on maturity of short-term liabilities to be useful to readers of the accounts.

Sensitivity analysis

FRS 7.40 requires that sensitivity analysis be disclosed for each type of market risk (interest rate risk, foreign exchange risk and other price risks, for example commodity price risk). The sensitivity analysis needs to show separately both the effect on profit and on equity that would occur if there were a reasonably possible change in the underlying index. This disclosure requires comparatives. The standard also requires the methods and assumptions used in performing the sensitivity analysis to be disclosed.

Other areas for improvement

A key aspect of the amendment to FRS 7 requires entities to classify financial instruments carried at fair value into a fair value hierarchy according to the levels of inputs into the measurement of financial instruments at fair value.

The fair value hierarchy consists of the following three levels:

- Level 1 - quoted prices (unadjusted) in active markets for identical assets or liabilities
- Level 2 - inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (ie as prices) or indirectly (ie derived from prices)
- Level 3 - inputs for the asset or liability that are not based on observable market data (unobservable inputs).

This disclosure requirement applies to all financial instruments carried at fair value. This includes available-for-sale financial assets measured at fair value as well as financial assets and financial liabilities at fair value through profit or loss. The extent of disclosure required depends on the inputs to the fair value measurement. At its simplest, fair value is measured directly using a quoted market price. However, it might be measured using a valuation model with various inputs, depending on the financial instrument in question. The more detailed disclosure is required for instruments at fair value where the inputs to the fair value measurement are not based on observable market data. Companies that have financial instruments held at fair value need to consider carefully what inputs are used in measuring fair value and therefore where the instrument sits within the hierarchy.

Common errors in the first year of providing these disclosures included misclassifying instruments between levels and including the fair value of instruments carried at amortised cost in the hierarchy disclosures, whereas such instruments should be excluded.

In the first year of application of the new requirement, there was an exemption from providing comparatives. As existing FRS preparers will now be in their second year of providing these disclosures, that exemption no longer applies, so comparatives will be required.

Impairment

Impairment testing and disclosure

Impairment testing under FRS 136 'Impairment of Assets' continues to be an important issue for many businesses, whilst the disclosures made about the impairment testing in the financial statements are an area of ongoing scrutiny by regulators. The process followed in testing for impairment may be complex and involve significant judgement, whilst the disclosure requirements are extensive.

The impairment testing process

Identification of cash-generating units

A cash-generating unit (CGU) is defined in FRS 136 as the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.

The first step in the impairment testing process is the identification of the CGUs that make up the business, as these CGUs will form the basis of the impairment tests. In addition, FRS 136 requires disclosures to be made by CGU.

Allocation of assets to cash-generating units

The next step is that the assets of the business must be allocated to CGUs. This includes goodwill, which must be allocated to CGUs at least to the level of operating segments identified under FRS 8 'Operating Segments'. The

allocation of assets to CGUs gives the carrying value which will be compared to the recoverable amount in order to determine whether there is impairment.

Identification of impairment indicators

The identification of impairment indicators is the third step in the process, in order to determine which CGUs will be tested for impairment.

CGUs to which goodwill or intangible assets with indefinite lives have been allocated, and intangible assets not yet available for use, are tested for impairment at least annually. Other CGUs are tested only when an indicator of impairment arises.

Calculation of recoverable amount

The recoverable amount of those CGUs that are required to be tested for impairment is then calculated. Recoverable amount is the higher of value in use and fair value less costs to sell.

Value in use is calculated using a discounted cash flow model, which requires key assumptions such as pre-tax discount rates and growth rates to be made for each CGU. Disclosure of these assumptions, together with information about how they have been determined, is required for each CGU.

Allocation of impairment losses

When the recoverable amount has

been calculated, any impairment loss is allocated to the assets of the CGU. Impairment losses are first allocated to goodwill until goodwill is reduced to nil. Any remaining impairment losses are then allocated across the other assets of the CGU on a pro rata basis, although no individual asset should be reduced below its own recoverable amount.

Impairment testing disclosures

FRS 136 requires extensive disclosure of information relating to different stages of the impairment process. The required disclosures should be given by CGU. In addition, there may be significant judgements, such as in the identification of CGUs, or key sources of estimation uncertainty arising from the impairment testing, which should be disclosed under FRS 101 'Presentation of Financial Statements'.

Discount rates and growth rates

The discount rates and growth rates used in calculating the recoverable amount of each CGU should be specific to the CGU and be disclosed. Where the same discount rates or growth rates are used for two or more CGUs, this may give rise to questions, in particular where those CGUs have performed differently historically or have different risk profiles, for example because they are in different geographic locations.

Significant changes in the discount rates or growth rates used compared to previous years should also be explained in the financial statements.

Approach to determining key assumptions

As well as disclosing the assumptions themselves, an explanation should be given as to how these have been determined. This should include the extent to which the assumptions reflect past experience or are consistent with external sources of information.

Period covered by budgets and beyond

The period over which the projected cash flows used in the impairment test are based on approved budgets or forecasts is required to be disclosed, with an explanation given where this exceeds five years. Assumptions should be disclosed for both the period covered by approved budgets and beyond this period.

The growth rate used to extrapolate beyond that period is then also required to be stated, and justification will be needed where this is higher than the long-term average growth for the products, industry or country in which the CGU operates.

Sensitivity disclosures

Where there is no impairment loss for a CGU, but the impairment test shows that there is little headroom

such that a reasonably possible change in a key assumption would result in an impairment, FRS 136 requires additional disclosures to be made. These include the amount of headroom on the impairment test for that CGU, the value assigned to the key assumption and the amount by which that assumption would need to change in order for the recoverable amount to be equal to the carrying amount of the CGU.



Segment Reporting

Identification of segments

Under FRS 8 'Operating Segments', segments are identified on the basis of the information reported to the Chief Operating Decision Maker (CODM) which is used to make operating decisions about the business.

If a group reports only a single segment in its operating segments disclosure, but narrative in the management commentary indicates that the group has diverse businesses or operates in a variety of geographic locations, this will bring into question whether the single segment disclosed is appropriate. If management commentary accompanying the financial statements discusses different businesses or identifies managers of different business streams, then this implies that this is how the group is managed and therefore the expectation is that information about these different businesses is reported to the CODM. Regulators have questioned companies about the disclosure of a single segment in these circumstances.

FRS 8 terminology

FRS 8 replaced FRS 114 'Segment Reporting' for periods beginning on or after 1 July 2009. In the first year of applying FRS 8, many groups have continued to give their segment disclosures using FRS 114 terminology such as primary and secondary segments, and business and geographic segments.

A simple way to improve segment disclosure is to make sure that FRS 8 terminology is used. This means that disclosure is given about the operating segments identified based on information reported to the CODM, with additional entity-wide disclosures also given about major customers, products and services and geographic locations.

Segment disclosures

The results and balances that FRS 8 requires to be disclosed for each operating segment are those which are actually reported to the CODM. This means that they will not necessarily be under FRS.

If the management commentary gives financial information or key performance indicators based on non-GAAP measures, then this suggests that management monitors the business and makes decisions on the basis of these non-GAAP figures. Therefore the operating segments disclosure in the notes to the financial statements would also be expected to be of non-GAAP information. Again, regulators have challenged companies when the segment disclosures are given using FRS information and this is inconsistent with the information given in management commentary. If information is reported to the CODM on a basis other than FRS, then the figures reported to the CODM for the total of the operating segments are required to be disclosed and reconciled to the FRS figures in the

primary statements.

Only one operating segment

Some groups do only have one reportable operating segment under FRS 8. However, they still need to make disclosures required by that standard.

Entity-wide disclosures

In addition to operating segment disclosures, FRS 8 requires entity-wide disclosures giving information about products and services, geographic locations and major customers to be given. These apply to all entities subject to FRS 8, including those that just have one reportable segment:

- revenues from external customers for each product and service
- revenues from external customers attributable to the entity's country of domicile and to all foreign countries in total (including the basis of attributing revenues to individual countries). If revenue amounts are material for an individual country this is disclosed separately
- certain non-current assets located
 - (i) in the entity's country of domicile and
 - (ii) located in all foreign countries in total in which the entity holds assets. If the assets are material for an individual country, these need to be disclosed separately.

The amounts reported in the entity-wide disclosures are FRS-based figures, not those used for internal reporting. This disclosure is required regardless of whether management uses this information to make operating decisions. Exemption is available only if the information is not readily available and would cost excessive amounts to obtain, in which case this fact should be disclosed.

If revenues from a single external customer amount to 10% or more of total revenue, FRS 8 requires that fact to be disclosed together with the total amount of revenue for each such customer. However, the name of the customer need not be stated.

No seriously prejudicial exemption

FRS 8 does not contain any exemption from any of its disclosures, not even due to the information being considered to be commercially sensitive or seriously prejudicial to the group's operations. Some regulators have acted in relation to this, and have made it clear that the disclosures required by FRS 8 are required even if management consider this to be seriously prejudicial to their business.



If you would like to find out how Grant Thornton can assist you and your business, please contact any of our offices near you.

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