

# CORPORATE REPORTING: CURRENT ISSUES

RELEVANT TO ACCA QUALIFICATION PAPER P2

**One of the features of the Paper P2 syllabus is a section on current issues. This is an area that can cover many different areas, including:**

- recently issued or revised financial reporting standards
- discussion papers and exposure drafts
- recent developments in international harmonisation
- Current business issues which impact financial reporting.

The Paper P2 exam typically includes a question dealing with current issues as the final question on the paper. The problem facing students is that there are many current issues, and so it is difficult to know where to focus study efforts. This article does not try to cover every current issue in the world of corporate reporting, but instead provides some information on three of the 'hot topics' that arise from documents issued by the International Accounting Standards Board (IASB). We will look at the issues of leasing, income tax and management commentary as these are all the subjects of examinable documents for exams in 2010.

## LEASES

In March 2009, the IASB and the FASB (Financial Accounting Standards Board – the source of US GAAP), published a discussion paper 'Leases: Preliminary Views'. This document is part of the IASB's long-term convergence project, the aim of which is to eliminate a variety of differences between IFRS and US GAAP.

The aim of the leases project is to develop a new single approach to lease accounting that would ensure that all assets and liabilities arising under lease arrangements are recognised in the statement of financial position (balance sheet). The topic of lease accounting has been long debated, with many preparers and users of financial statements claiming that the current treatment under IAS 17, *Leases* is too subjective and can too easily result in off-balance sheet finance.

The Discussion Paper is extremely significant, because it proposes a fundamental change in the way that leases are accounted for. It introduces the 'right-of-use' model, under which

the lessee will recognise an asset and a liability for all leases entered into. This effectively eliminates the current category of an operating lease, and would ensure that all leases are treated in a consistent way. This change would have a massive impact in terms of financial reporting for the many companies who use operating leases within their business as all leases would now have to be recognised, with implications for measures such as return on capital employed and liquidity ratios.

The accounting treatment is explained as follows. The asset represents the lessee's right to use the leased item for the lease term (hence the term 'right-of-use' model) and the liability represents the obligation to pay rentals. The asset would be initially recognised at cost, with cost defined as 'the present value of the lease payments discounted using the lessee's incremental borrowing rate'. The asset would be amortised over the shorter of the lease term and the economic life of the asset, or if the lessee expects to obtain the title to the asset at the end of the lease term, over the economic life of the asset.

The liability would be recognised initially at the same amount as the asset, ie 'the present value of the lease payments discounted using the lessee's incremental borrowing rate'. The liability would be subsequently amortised using an amortised cost-based approach.

The Discussion Paper also includes proposals on more complex issues, such as renewal options, contingent rentals, and residual value guarantees. All of the proposals are focused on lessee accounting. It is thought that lessor accounting will be dealt with once the tentative proposals in the Discussion Paper have been fully considered by the IASB.

To conclude on leases, if the proposals do eventually form the basis of a new financial reporting standard, it will be one of the most significant developments to arise from the IASB's convergence project. Having one method to account for all types of leases will go a long way to improve consistency and comparability, though some may argue that using one method for all types of lease is too simplistic. An Exposure Draft

on leases is expected in the third quarter of 2010.

## INCOME TAX

In March 2009, the IASB issued an Exposure Draft 'Income Tax'. This exposure draft is also part of the IASB's long-term convergence project. The Exposure Draft is proposing to replace IAS 12, *Income Taxes* and is an examinable document for Paper P2 exams in 2010.

The proposals retain the basic IAS 12 approach to accounting for deferred tax, known as the temporary difference approach. The objective of that approach is to recognise immediately the future tax consequences of past events and transactions. Although the proposals retain the same basic principle, the IASB intends to change the methodology used to calculate deferred tax, change some of the definitions, eliminate some recognition exceptions, and introduce guidance on dealing with uncertainties. In addition, the IASB proposes a changed structure for the standard that will make it easier to use. The proposals also more closely align with FASB Statement 109, *Accounting for Income Taxes*, though some differences may remain.

A change in the methodology used to calculate deferred tax assets and liabilities is proposed. It would only be necessary to consider deferred tax in respect of assets and liabilities where the company expects the recovery or settlement of the carrying amount to affect taxable profit. For example, if a nil tax rate would apply to any taxable or deductible amounts, then no deferred tax arises, as there is no future tax consequence.

A new definition for 'tax basis' (previously known as 'tax base') is proposed as 'the measurement, under applicable substantively enacted tax law, of an asset, liability or other item'. The definition is not very different from before, but the further guidance in the Exposure Draft makes an important point that the tax basis of an asset should be determined based on the assumption that an asset will be sold, and for liabilities on the assumption that the liability will be settled for its carrying amount.

THE TOPIC OF LEASE ACCOUNTING HAS BEEN LONG DEBATED, WITH MANY PREPARERS AND USERS OF FINANCIAL STATEMENTS CLAIMING THAT THE CURRENT TREATMENT UNDER IAS 17, LEASES, IS TOO SUBJECTIVE AND CAN TOO EASILY RESULT IN OFF-BALANCE SHEET FINANCE.

The Exposure Draft proposes the elimination of recognition exceptions on initial recognition of assets and liabilities and for many investments. The current IAS 12 exception prohibits the recognition of deferred tax liabilities and assets in relation to temporary differences arising on the initial recognition of an asset or liability (other than in a business combination where the asset or liability does not impact accounting profit or taxable profit at the time of recognition). The proposal could result in the recognition of deferred tax arising on the difference between the initial carrying amount of an asset or liability and its tax basis, even if the recognition is nothing to do with a business combination. It is therefore likely that many more balances recognised in the financial statements could result in an associated deferred tax asset or liability.

New guidance has been included to help companies to account for uncertain tax positions. A probability weighted average amount of all possible outcomes should be calculated, based on the assumption that the tax authorities will review the amounts submitted and have full knowledge of all relevant information. Examples of the calculation are provided in the Exposure Draft. In conclusion, there are many detailed changes proposed in relation to the calculation and recognition of deferred tax, though the fundamental principle of comparing book values with tax bases in determining temporary differences remains unchanged.

#### MANAGEMENT COMMENTARY

Most large companies provide some kind of management commentary, which is published alongside the financial statements. The commentary could be known as an Operating and Financial Review (OFR), Business Review, Management's Discussion and Analysis (MD&A) or Management's Report. Management commentary is therefore already an important means by which companies communicate with capital markets and with their stakeholders. In some jurisdictions there is already a framework to be used by companies in preparing management commentary, and indeed in some countries there are

specific legal requirements regarding its content.

In June 2009 the IASB published an Exposure Draft 'Management Commentary' which proposes a framework for the preparation and presentation of management commentary to accompany financial statements that are prepared under IFRS. The intention is that the final document would have the status of a best practice framework. Following the framework would not be compulsory, and the framework could be adapted to the legal and economic circumstances of individual jurisdictions.

The Exposure Draft states that the purpose of management commentary is to provide existing and potential capital providers with information that helps them place the related financial statements in context. Management commentary should explain management's view on not only what has happened, but also why management believes it has happened and what management believes the implications are for the entity's future. It should explain the main trends and factors that are likely to affect the entity's future performance, position and development. Consequently, management commentary looks not only at the present, but also at the past and the future.

The IASB proposes that management commentary should contain information on the following:

- ▣ the nature of the business
- ▣ management's objectives and strategies for meeting those objectives
- ▣ the entity's most significant resources, risks and relationships
- ▣ the results of operations and prospects, and
- ▣ the critical performance measures and indicators that management uses to evaluate the entity's performance against stated objectives.

The Exposure Draft provides detailed guidance as to the types of disclosures that would be relevant for each of the categories above. In brief, there should be a mixture of narrative and numerical disclosures, and the performance measures should be both financial and non-financial in nature.

Consistent reporting of performance measures and indicators increases the comparability of management commentary over time. However, as strategies and objectives change, management might decide that the performance measures and indicators presented in the previous period management commentary are no longer relevant. Therefore, the content of management commentary should be seen as something that continually evolves over time, to match with changes in the company itself. In conclusion, management commentary should supplement and complement the financial statements, include orientation to the future, and fairly present the views of management on the relationship between the financial statements and the company's strategies and objectives.

#### ADVICE TO STUDENTS

This article has looked at three of the many current issues in corporate reporting. In the past few Paper P2 exams, current issues have been tested in the final question of the paper, using a mixture of requirements asking for narrative and numerical answers. Though the subject matter has not been covered in this article, I would recommend that students read Question 4 from the December 2009 session (this question was on complexity in the measurement of financial instruments and was based on the relevant Exposure Drafts on financial instruments), and from the June 2009 exam session (this question was on employee benefits and again based on the relevant Exposure Draft). The papers can be downloaded from the student section of the ACCA's website at [www.accaglobal.com/students/acca/exams/p2/past\\_papers](http://www.accaglobal.com/students/acca/exams/p2/past_papers).

I would also recommend further reading on the topics covered in this article. The documents can be downloaded from the IASB website at [www.iasb.org](http://www.iasb.org). Students should refer to the examinable documents published on the ACCA website for details of examinable exposure drafts and discussion papers.

**Lisa Weaver is examiner for Paper P7**