OBSERVATIONS ON SELECTED FINANCIAL REPORTING ISSUES

ISSUERS' FINANCIAL YEARS ENDING ON OR AFTER 31 DECEMBER, 2010

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MISSION

To support and enhance public confidence in the accountancy profession and in financial reporting through the exercise of effective, independent oversight and the promotion of adherence to high standards

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PREFACE

1. Financial reporting environment

In presenting their results and financial positions in respect of financial years ending on or after 31 December, 2010, issuers continue to report in the midst of a challenging domestic environment and against the backdrop of an uncertain international economic outlook. The combination of these factors gives rise to ongoing risk and uncertainty in the recognition, measurement and classification of revenues, expenses, assets and liabilities in periodic financial reports as well as to associated risks in the context of presentation and disclosure.

The aforementioned ongoing risk and uncertainty places a continued emphasis on the critical importance of estimates and judgments made in preparing financial reports and on the importance of the role played by Boards and Audit Committees in considering and approving issuers' periodic financial reports.

2. General comments on financial reporting by issuers coming within IAASA's review constituency

IAASA commenced its examination of periodic financial reports in late 2007 and by the end of 2010 had completed its first cycle of reviews of such reports. Having regard to the experience gained over that period, set out below are some general comments on financial reporting matters. These comments should be read in conjunction with the specific observations outlined on pages 12 to 22 of this document.

2.1 Meeting the needs and expectations of users of financial reports

Much of IAASA's work with regard to its financial reporting supervision function involves intensive engagement with issuers' Boards on complex recognition and measurement issues. If, as a result of such engagement, it is determined that the amounts recognised in financial statements have not been arrived at in accordance with the requirements of relevant accounting standards, those amounts require to be amended by way of either:

(a) the publication of a revised financial report; or

(b) the effecting of appropriate amendments in a subsequent financial report.

In circumstances where the recognition and measurement of the amounts presented in financial statements appear to be in accordance with the requirements of relevant accounting standards, IAASA may nevertheless form the view that more extensive disclosures are required in order to either:

(a) meet minimum disclosure requirements; or

(b) otherwise aid users' understanding of the financial statements.

While IAASA is pleased to note that, in general, directors of reviewed issuers have engaged positively and constructively on such issues, it is disappointing that IAASA has, in a number of instances, encountered resistance from Boards and Audit Committees against the provision of disclosures to address (i) and/or (ii) above.

In circumstances where IAASA is of the view that disclosures over and above minimum requirements are required in users' interests, it will continue to seek to work with issuers' Boards to achieve that end. Boards who resist such suggestions should note that this is factored into their risk profiles.

2.2 Quality of 'front end' reporting

Previous Observations documents[1] have commented on the quality of information contained in what is commonly termed as the 'front end' of financial reports[2]. In common with peer accounting enforcers' experiences, IAASA has observed that issuers' front end reporting is of variable standard, with some

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[1] For example, sections 2.9, 2.10 and certain items in 2.7 of IAASA's 2009 Observations document refer

[2] Front end reporting includes, for example, the Chairman's Statement, Chief Executive's Review, Financial Review and the Report of the Directors

Boards opting for boilerplate language that often fails to provide users with any particular insights into issuers' business models and the risks and uncertainties associated therewith (i.e. information that is not particularly decision useful).

Front end reporting should be user-needs driven and not 'boilerplate' and should be consistent with other elements of periodic financial reports. In current market conditions, issuers need to focus on ways to effectively communicate with a broad range of users as to how the business has performed during the period. Boards and Audit Committees are, therefore, encouraged to carefully consider the contents of their reports with a view to ensuring that they meet users' needs, in particular that they are:

(a) comprehensive;

(b) balanced; and

(c) reflective of the size and complexity of the business.

In the context of the foregoing, issuers' attention is drawn the IFRS Practice Statement '*Management Commentary*'[3], published by the IASB[4] in December 2010. The Statement provides a broad, non-binding, framework for the presentation of management commentary prepared to accompany IFRS financial statements.

The Practice Statement is not an IFRS. Consequently, compliance therewith is not mandatory. Nevertheless, issuers' Boards are encouraged to study the document with a view to identifying whether their current standard of narrative reporting can be enhanced in users' interests.

The Statement states that management commentary:

(a) is narrative reporting that provides a context within which to interpret the financial position, financial performance and cash flows of an entity;

(b) also provides management with an opportunity to explain its objectives and its strategies for achieving those objectives.

Users routinely use the type of information provided in management commentary to help them in evaluating an issuer's prospects and its general risks, as well as the success of management's strategies for achieving its stated objectives. For many issuers, management commentary is an important element of their communication with the capital markets, supplementing as well as complementing the financial statements.

2.3 Materiality

In May 2010, IAASA published a paper entitled '*Observations on Materiality in Financial Reporting*'[5], for the purposes of:

(a) providing interested parties with an overview of the requirements of IFRS with respect to the assessment of the materiality of omissions or misstatements; and

(b) outlining IAASA's observations arising from its engagement with issuers in respect of their materiality judgments.

Some of the Paper's main observations included:

(a) in making a materiality assessment, IFRS requires consideration as to whether an omission or misstatement **could** [emphasis added] influence the economic decisions that users make[6].

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[3] Available at http://www.ifrs.org/Current+Projects/IASB+Projects/Management+Commentary/IFRS+Practice+Statement/IFRS+Practice+Statement.htm

[4] International Accounting Standards Board

[5] Available at http://www.iaasa.ie/publications/Obs_materiality2010.pdf

Thus, the information does not have to change a decision, but rather it must merely have the capacity to influence it;

(b) issuers' assessments of materiality can be unduly focused on the needs of a limited range of users. Preparers must focus on all users of financial statements when making materiality determinations and not simply on investors/potential investors[7];

(c) materiality assessments are not determined by a simple quantitative comparison to primary financial statement totals but, rather, encompass evaluation of a range of factors. For example, amounts which are relatively insignificant in comparison with the overall results of the entity may nonetheless be highly qualitatively material to a user; and

(d) IFRS does not permit intentional errors, however immaterial, to remain uncorrected. Therefore, the circumstances surrounding a preparer's decision not to correct an identified and easily corrected error requires careful consideration in the context of a materiality judgement.

2.4 Directors' responsibility for financial statements

Transparency law requires issuers' directors to prepare periodic financial reports, including financial statements. While, in practice, the task of preparing financial statements is usually delegated to management (or, in the case of funds and debt issuers, to third party service providers), it is important that issuers' Boards and Audit Committees understand that ultimate responsibility for the financial statements resides solely with the directors and that this responsibility cannot be delegated.

2.5 Debt and fund issuers

While IAASA's engagement with fund and debt issuers' Boards has, in the main, been positive and constructive, it is nevertheless a source of disappointment that:

(a) certain issuers have had cause to revise and re-file periodic financial reports in successive accounting periods, which suggests that lessons that should have been learned from previous reviews are not in fact being learned;

(b) responses received to IAASA correspondence can lack sufficiently detailed information and, in some cases, have failed to address queries raised. Such failures and deficiencies, which are avoidable through more carefully considered responses, can give rise to protracted correspondence with the Boards in question, thereby leading to increased costs for the issuers concerned;

(c) issuers' responses to issues raised suggest a tendency on the part of fund and debt issuers as a body to take a narrow interpretation as to the users of their periodic financial reports;

(d) the overall quality control processes in place prior to the publication of the periodic financial reports of such issuers appear to be weaker than those applied by equity issuers resulting in a generally poorer standard of financial reports being published; and

(e) identical, or similar, instances of non-compliance are being identified in the periodic financial reports of issuers having common directors or advisers.

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[6] Paragraph QC 11 of *The Conceptual Framework for Financial Reporting*, issued by the IASB in September, 2010, states that '*Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific entity*.'

[7] Paragraph OB2 of *The Conceptual Framework for Financial Reporting*, issued by the IASB in September, 2010, states that '*The objective of general purpose financial reporting is to provided financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity'* and paragraph OB10 states '*Other parties, such as regulators and members of the public other than investors, lenders and other creditors, may also find general purpose financial reports useful. However, those reports are not primarily directed to those other groups.*'

In response, IAASA is proposing to undertake a number of initiatives to address shortcomings in such issuers' periodic financial reporting processes. These initiatives include:

(a) exploring the feasibility of reducing the necessity for protracted correspondence with issuers through the greater use of meetings with issuers and their advisors; and

(b) exploring the possibility of running seminars with interested parties to draw attention to, and discuss, financial reporting issues.

INTRODUCTION TO OBSERVATIONS

1. IAASA's financial reporting supervision function

The Transparency (Directive 2004/109/EC) Regulations 2007 (S.I. No. 277 of 2007) ('the Regulations') provide that IAASA has responsibility for examining whether the annual and half-yearly financial reports (collectively referred to as 'periodic financial reports') of certain entities whose securities have been admitted to trading on a regulated market, situated, or operating, within the EU[8] (referred to as 'issuers') have been drawn up in accordance with the relevant reporting framework. IAASA's review constituency under the Regulations extends to approximately 168 issuers, comprising issuers of equity (31), debt (92) and closed ended funds (45)[9]. Constituent issuers publish approximately 300 periodic financial reports per annum.

2. Reviewed periodic financial reports forming the basis for this document

For the majority of issuers, annual financial reports in respect of the year ended 31 December, 2009 and half-yearly reports in respect of the six months ended 30 June, 2010 formed the basis of IAASA's financial reporting review activity during 2010.

The majority of issuers that are required to make public their periodic financial reports in compliance with the Regulations apply either International Financial Reporting Standards ('IFRS') (such issuers being referred to as 'IFRS issuers') or accounting standards issued by the Accounting Standards Board ('ASB'), (such issuers being referred to as 'Irish GAAP[10] issuers').

While IAASA does also examine and, where considered necessary, take appropriate enforcement action in respect of the periodic financial reporting of issuers that use other codes of accounting standards (e.g. US GAAP), a large majority of issuers coming within remit use either IFRS or Irish GAAP and, for that reason, the observations offered in this document are confined to the requirements as they apply to IFRS and Irish GAAP issuers.

3. Purpose of this document

In common with the previous two years when IAASA published *Observations* documents[11], the purpose of this document is twofold, namely to:

(a) seek to assist issuers' Boards and Audit Committees in preparing high quality financial reports by offering observations on selected financial reporting issues to coincide with the preparation of issuers' 2010 financial statements; and

(b) provide those charged with issuers' governance and other interested parties with an understanding of IAASA's likely approach in dealing with certain matters when examining financial reports during 2011.

4. Relevance of matters raised in previous *Observations* documents

Certain of the issues referred to in IAASA's *Observations* documents published in January 2009 and January 2008 respectively continued to be relevant throughout 2010. Accordingly, many issues referred to in those documents remain applicable in the current reporting season. Consequently, readers should study this document in conjunction with those earlier documents.

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[8] 'EU' should be read as including all EEA States i.e. EU Member States and Norway, Iceland and Liechtenstein

[9] As at 31 December, 2009; Table 17 of the Authority's 2009 Annual Report refers

[10] Generally Accepted Accounting Principles

[11] *Observations on selected financial reporting issues – issuers' financial years ending on or after 31 December, 2009* available at http://www.iaasa.ie/publications/Obsdoc_Jan10.pdf and *Observations on year end financial reporting issues for issuers admitted to trading on a regulated market and whose Home Member State is Ireland* available at http://www.iaasa.ie/publications/FRSUobs_Jan09.pdf

5. Other relevant guidance and feedback material

Readers may also find it helpful to read this document in conjunction with other relevant material available on the IAASA website, including:

(a) previous Annual Reports[12];

(b) *Observations on Materiality in Financial Reporting*[13]

(c) the *Commentary* on issuers' half yearly financial reporting[14]; and

(d) periodically published summaries of enforcement decisions taken by EU financial reporting supervisory authorities[15], the eighth and ninth of which were published during 2010.

6. Enforcement

Periodic financial reports are public documents which are required by transparency law to give a true and fair view of issuers':

(a) financial performance during the reporting period; and

(b) financial position at the reporting date.

Where information published in a periodic financial report constitutes an infringement of the relevant reporting framework, this may lead to users of periodic financial reports:

(a) being denied information relevant to their decision-making; and/or

(b) being misled in respect of an issuer's financial position and performance.

It is important, therefore, that infringements, once identified, are addressed in an appropriate manner in users' interests. In that context, IAASA's approach to date has been to seek to ensure that:

(a) identified infringements do not recur, i.e. by seeking and obtaining directors' undertakings, or otherwise agreeing steps with the issuer's directors, to effect necessary improvements in future reports, together with, where necessary, the restatement of prior amounts and provision of associated explanations; and

(b) infringements of a more serious nature, i.e. infringements which could adversely affect users' interests if uncorrected, are corrected by way of the timely publication of revised financial information. In seeking to ensure that, where appropriate, revised information is provided to the market, IAASA's practice, wherever practicable, is to engage with affected issuers' directors with a view to securing the voluntary publication of such revised information.

IAASA determines the most appropriate response to each identified infringement by reference to the individual circumstances of each case and having formed a judgment as to whether the size, nature and/or circumstances of the identified infringement, together with the number of infringements involved, is such that users' interests are best served by the publication of revised information or, alternatively, whether undertakings to ensure that the infringement does not recur are sufficient.

As a consequence of the above approach, IAASA has, to date, been able to secure the necessary improvements to issuers' financial reporting without having had to invoke its statutory powers, which under the Regulations are considerable. The foregoing approach is, in IAASA's assessment, the most time and cost effective from both IAASA's and issuers' perspectives. It remains therefore IAASA's preferred means of securing required improvements to issuers' statutory financial reporting.

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[12] These Annual Reports are available at http://www.iaasa.ie/publications/index.htm
[13] Available at http://www.iaasa.ie/publications/Obs_materiality2010.pdf
[14] The Commentary is available at http://www.iaasa.ie/publications/TD_Commentary2008.pdf
[15] These summaries can be accessed at http://www.iaasa.ie/publications/index.htm in the '*Third-party Publications*' section

Notwithstanding the foregoing, IAASA will continue to carefully monitor and assess issuers' responses to identified infringements and to consider whether, having regard to all relevant factors, it is necessary or otherwise appropriate in users' ,or the wider public's, interest to exercise its statutory enforcement powers. The full text of the Regulations can be accessed on IAASA's website[16].

7. IAASA's approach towards issues arising from reviews of periodic financial reports

The approach adopted by IAASA towards issues arising from reviews of periodic financial reports was set out in Section 2.6 of Chapter 4 of the 2009 Annual Report[17].

It is IAASA's expectation that, in the future, increasing use will be made of meetings with issuers' representatives to resolve issues rather than relying exclusively on correspondence as has been the case in the majority of cases heretofore. IAASA believes that face to face meetings with issuers' representatives has the potential to result in greater clarity in the identification of apparent infringements and the determination of the appropriate remedial actions on a more timely and cost effective basis.

Furthermore, as a majority of the issuers coming within IAASA's remit will have been subject to an IAASA review by the end of 2010, issuers have, in general, developed an appreciation of the role, function and *modus operandi* of IAASA. As a consequence, it is IAASA's expectation that:

(a) the quality of issuers' periodic financial statements will show a higher level of compliance with the relevant reporting framework; and

(b) in the event that IAASA corresponds with issuers, the quality of responses from issuers will be commensurately high.

[16] http://www.iaasa.eu/legislation/si277_2007.pdf
[17] Available at http://www.iaasa.ie/publications/Annual_Report2009_Ch4.pdf

OBSERVATIONS ON SELECTED FINANCIAL REPORTING ISSUES

1. Financial instruments

1.1 Recognition and measurement

Continued illiquidity in financial markets for certain financial instruments has continued to present risks and challenges to preparers, i.e. that the fair values attributed to affected financial instruments might not adequately reflect current market conditions.

In light of such risks and challenges, IAASA considered it appropriate to examine selected issuers' measurement and recognition policies during the year. Unsurprisingly, this review activity identified an increased incidence of the use of valuation techniques by issuers.

In that context, IAASA's review activities indicated that, in certain instances, it was unclear as to:

(a) the valuation techniques most frequently applied by issuers;

(b) whether there had been changes to the valuation policies applied;

(c) if so, the nature of such changes;

(d) the significant assumptions underpinning valuation policies.

In view of the foregoing, in circumstances where illiquidity continued to be an issue during 2010, Boards and Audit Committees should satisfy themselves as to the appropriateness of the valuation techniques, and associated assumptions and judgements, being adopted and applied by management for financial reporting purposes. Boards and Audit Committees should further satisfy themselves that the disclosures to be provided in that regard sufficiently cater for users' needs.

Moreover, given the materiality of the investments in relevant financial instruments by some issuers, it is likely that, during 2011, IAASA will continue to monitor relevant issuers' approach towards these risks and challenges and, where considered necessary, to seek clarifications and explanations in that regard.

1.2 Fair value disclosures

Paragraph 122 of IAS 1 *Presentation of Financial Statements* requires issuers to disclose the judgements, apart from those involving estimations, that management has made in the process of applying the entity's accounting policies and that have the most significant effect on the amounts recognised in the financial statements. Consequently, issuers' selection of valuation techniques and application of assumptions to those techniques can have a significant effect on the amounts recognised in the financial statements.

Paragraph 27 IFRS 7 requires issuers to disclose - for each class of financial instrument:

(a) the methods; and

(b) where a valuation technique is used, the assumptions applied in determining fair values of each class of financial assets or financial liabilities.

In addition, for fair value measurements in Level 3[18], if changing one or more of the inputs to '*reasonably possible alternative assumptions*' would change fair value significantly, issuers are required to state that fact and to disclose the effect of those changes in accordance with paragraph 27B(e) of IFRS 7.

During the course of its review activity, IAASA has observed that a number of issuers - in particular, but not limited to, fund and debt issuers - describe a range of valuation techniques that may be applied generally in the measurement of the fair values but without specifying which valuation

[18] Level 3 prices are those whose inputs are not based on observable market data (unobservable inputs) (paragraph 27A of IFRS 7 refers).

techniques have in fact been applied or the significant assumptions underpinning each significant valuation technique that has been applied.

Where such issues have been identified, IAASA has sought clarifications and additional information from Boards. Arising from those enquiries a number of issuers have provided undertakings to clarify, in future financial reports, the valuation techniques most frequently applied and the nature of the most significant assumptions underpinning same.

Based on IAASA's review experience, where issuers' circumstances have changed, for example, a material increase in the proportion of its financial instruments that are classified as Level 3[18] prices or changes in the valuation techniques applied during the period, it has not always been apparent that the required disclosures have been reflected in the notes to the financial statements.

In view of the foregoing, Boards and Audit Committees are encouraged to ensure that, where there has been a change in the issuer's circumstances, management's approach towards the valuation of financial instruments is appropriate and fully reflects the issuer's particular circumstances.

1.3 Risk disclosures
IAASA's review activity suggests that the quality of issuers' risk reporting varies across the three classes of issuer, with equity issuers in general having been found to demonstrate a higher standard of compliance with IFRS than debt and fund issuers.

Given the continued challenging economic environment in which issuers operate, IAASA has considered it necessary to remain focussed on issuers' standard of risk reporting, particularly on whether issuers' risk reporting is sufficiently comprehensive to address users' needs.

IAASA has noted that the following disclosures remain problematic for some issuers and have, as result, lead to correspondence with issuers. As a result, in most cases issuers have undertaken to either clarify and or enhance their risk disclosures in future periodic reports:

(a) *Credit risk*
It is important that issuers disclose the credit quality of financial instruments. This information is helpful to users' assessment of the credit risk of assets and whether or not they are likely to become impaired in future periods;

(b) *Liquidity risk*
Issuers' financial reports should clearly explain the entity's liquidity strategy and the risks to that strategy consistent with the quantitative data provided in the financial statements. Where the liquidity analysis, which is based on the contractual maturities of liabilities, is not expected to reflect the contractual maturity of liabilities, issuers are required to provide a description of how the entity intends to manage the liquidity risk. This may include, for example, committed borrowing facilities, off balance sheet guarantees or a description of liquid assets available to be used as collateral;

(c) *Counterparty risk*
Where issuers engage with a limited number of counterparties, and albeit that these may be highly reputable entities, the reporting entity's potential risk to the counterparties should be disclosed. Counterparty risk in fund and debt issuers can arise from entities' engagements with financial institutions with whom liquid deposits are maintained or with whom assets are held (custodians) as well as with counterparties to derivative instruments;

(d) *Concentration risk*
In examining risk disclosures, Boards and Audit Committees should remain vigilant that concentration risk is identified and, where significant, is clearly disclosed in order to assist users' understanding of the risks arising. Concentration risk can arise from the type of assets held, the maturity of assets, the concentration of sources of funding and/or the concentration of counterparties;

(e) *Sensitivity analysis (other price risk, interest rate risk, foreign currency risk)*

The provision of sensitivity analysis is necessary in order to assist users in understanding the uncertainty in valuations(other price risk) and other risks such as (but not limited to) interest rate risk and currency risk. The sensitivity analysis is required to be based on reasonably possible assumptions, rather than worse case scenarios or unexpected outcomes. In the case of certain fund and debt issuers, sensitivity analyses have been found to be boilerplate and not user-specific and the rationale for the rate of the sensitivity analysis reported was not always apparent.

Boards and Audit Committees are, therefore, encouraged to satisfy themselves that the disclosures provided in respect of the risks associated with financial instruments are sufficiently clear and comprehensive in order to enable users to properly understand the impact of particular transactions, other events and conditions on the issuer's performance and financial position. Meaningful and comprehensive risk disclosures are those which clearly communicate the principal risks to which an issuer is exposed and:

(a) changes, if any, to those risks that have occurred during the period; and

(b) changes, if any, in the manner in which those risks are managed/mitigated.

Providing risk disclosures comparable with peers does not ensure compliance with IFRS insofar as peer entities may not have comparable risk profiles or risk strategies and peer entity directors may view and manage risks differently.

2. Impairments

Given prevailing economic conditions and the associated continuing downward pressure on asset values and future earnings streams, careful attention to the requirements of those accounting pronouncements relating to the impairment of assets, and in particular goodwill[19], continues to be important in the context of the potential impact on profit/loss for the period.

In this regard, the discount rate applied to discount estimated future cash flows is a key factor in the determination of the level of impairment, if any, to be recognised. Similarly, the amount and timing of expected future cash flows are important determinants in any impairment calculation.

IAS 36 *Impairment of Assets* requires that:

'*the discount rate used shall be a pre-tax rate (rates) that reflect(s) current market assessments of:*

(a) the time value of money; and

(b) the risks specific to the asset for which the future cash flow estimates have not been adjusted.'[20]

Paragraphs 56, 57 and A15 to A21 of IAS 36 set out additional requirements in this regard.

It is IAASA's expectation that Boards and Audit Committees will carefully assess the basis on which such discount rates have been determined and will consider the level of disclosure required in periodic financial reports regarding the discount rate(s) used[21] to provide decision useful information to users of those financial statements.

3. Pension accounting and discount rates

[19] IAS 16 *Property, Plant and Equipment* dealing with the recognition and measurement of tangible assets, IAS 19 *Employee Benefits* dealing with the recognition and measurement of pension scheme assets, IAS 36 *Impairment of Assets* dealing with goodwill and other assets, IAS 39 *Financial instruments: Recognition and Measurement*, and IAS 40 *Investment Property*. For Irish GAAP issuers, the equivalent FRSs are FRS 15 *Tangible fixed assets*, FRS 17 *Retirement benefits*, FRS 11 *Impairment of fixed assets and goodwill,* FRS 26 *(IAS 39) Financial Instruments: Recognition and measurement* and SSAP 19 *Accounting for investment properties*

[20] Paragraph 55 of IAS 36. For Irish GAAP issuers, paragraphs 41 to 46 of FRS 11 *Impairment of fixed assets and goodwill* refer

[21] Paragraphs 130(g), 132, 134(d)(v), 134(e)(v) 134(f) and 135(e) of IAS 36 refer

In determining the pension asset or liability recognised under IAS 19 *Employee Benefits*[22] a key actuarial assumption is the rate used to discount post-retirement benefit obligations. IAS 19 requires that the discount rate used shall be determined by reference to market yields at the end of the reporting period on high quality corporate bonds. In countries where there is no deep market in such bonds, the market yields at the end of the reporting period on Government bonds shall be used. IAS 19 further requires that the currency and term of the corporate bonds or Government bonds shall be consistent with the currency and estimated term of the post-employment benefit obligations[23]. FRS 17[24] contains broadly equivalent requirements[25].

In that context, Boards and Audit Committees should carefully assess the assumptions used by actuaries in preparing actuarial valuations and may need to challenge those assumptions by questioning the actuary on matters such as:

(a) the basis on which the discount rate has been determined (e.g. a corporate bond rate, a Government bond rate, evidence of there being/not being a deep market in such bonds);

(b) the sensitivity of the discount rates that have been used;

(c) the consistency of discount rates used with those used for investment returns; and

(d) whether or not the overall results of the actuarial valuation accord with expectations and the underlying economic substance.

4. Bank covenants

IFRS 7 requires issuers to disclose information regarding the nature and extent of risks arising from financial instruments.

In the current economic environment, where issuers may be facing the risk of breaching bank covenants (with the result that financing could fall for immediate repayment under the terms of the loan facility agreement), there may be instances where disclosing the nature of such covenants and the extent to which the issuer may or may not continue to be in compliance with same will be required in order to comply with the requirements of IFRS 7.

It is IAASA's expectation that Boards and Audit Committees will carefully evaluate the circumstances surrounding the extent of compliance or otherwise with bank covenants and will carefully evaluate the risks associated with possible non-compliance. Furthermore, IAASA expects that disclosures provided in periodic financial reports will reflect the results of this evaluation and, as a consequence, that disclosures provided will be sufficient to enable users to evaluate the significance of compliance or otherwise with bank covenants for the issuer's financial position and performance and the nature and extent of risks arising from financial instruments to which the issuer is exposed.

5. Disclosure of Key Management Personnel ('KMP') compensation

IAS 24 *Related Party Disclosures*[26] requires the disclosure of KMP compensation in total and for each of the following categories:

(a) short-term benefits;

(b) post-retirement benefits;

(c) other long-term benefits;

(d) termination benefits; and

[22] For issuers applying Irish GAAP, FRS 17 *Retirement benefits* is the relevant accounting pronouncement
[23] Paragraph 78 of IAS 19 refers
[24] FRS 17 *Retirement benefits*
[25] Paragraphs 32 to 34 of FRS 17 refer
[26] For Irish GAAP issuer, FRS 8 *Related party disclosures* is the applicable Standard

(e) share-based payment[27].

The term '*key management*' is defined as '*...those persons having authority and responsibility for planning, directing and controlling the activities of the entity, directly or indirectly, including any director (whether executive or otherwise) of that entity*'[28].

IAASA has observed a number of instances of non-compliance with these requirements, including the failure to include details of compensation paid to all directors (i.e. executive and non-executive directors) in the KMP compensation disclosures.

Given that the IAS 24 requirements in this regard are clear and have been in place for a number of years, it is not acceptable that certain issuers continue to fail in this regard, particularly given the sensitivity of the required disclosures. It is, therefore, IAASA's clear expectation that issuers will include directors' compensation amounts in the KMP compensation disclosures required by IAS 24 and that such disclosure will be in addition to any requirement to disclosure directors' remuneration under company law and the Listing Rules.

A further matter worth highlighting in this context is the requirement in IAS 1 that financial statements should be clearly identified and distinguished from other information in the published document. In that context, it is noted that certain issuers do not provide directors' remuneration in their KMP disclosures as part of related party disclosures, referring readers instead to the directors' remuneration statement, usually provided as part of the Corporate Governance section of the Annual Report. However, since such information is outside of the audited financial statements and is generally scoped out of the auditors' report, users cannot identify whether such information has been audited. Moreover, in many instances such information would not meet the requirements of IAS 24 in any event, omitting members of KMP who may not be directors, as well as failing to include certain benefits such as share-based payment amounts.

6. Revision to IAS 1 *Presentation of Financial Statements*

IAS 1 was revised with effect from 1 January, 2009 and brought changes to the way in which entities present their primary financial statements, as well as some changes to the accompanying notes.

An issue worth highlighting is the IAS 1 (revised) requirement that where an entity:

(a) applies an accounting policy retrospectively;

(b) makes a retrospective restatement; or

(c) reclassifies items in the financial statements,

a third Balance Sheet as at the beginning of the earliest comparative period is presented. However, despite entities reclassifying certain comparative amounts, IAASA has observed a number of instances in which there has been a failure to present a third Balance Sheet. Moreover, disclosures as to the reasons for such reclassification can be uninformative, with explanations such as '*more appropriate*' and '*consistent with the current year*' failing to provide the user with any genuine insight as to the reason for the change.

It is IAASA's expectation that the incidence of issuers providing a second such comparative Balance Sheet will increase as issuers meet the requirement of IAS 1 (revised)

7. Operating Segments

IFRS 8 *Operating Segments*[29] is effective for annual accounting periods beginning on or after 1 January, 2009. The financial and descriptive disclosure requirements of IFRS 8 are based on the

[27] Paragraph 17 of IAS 24 (revised) refers. FRS 8 does not require disclosure of KMP compensation
[28] Paragraph 9 of IAS 24
[29] For Irish GAAP issuers, Statement of Standard Accounting Practice ('SSAP') 25 *Segmental reporting* is the relevant Standard

information regarding the components of the entity that management uses to make decisions about operating matters[30] (i.e. a '*management approach*').

IFRS 8 requires an issuer, including an issuer with a single reportable segment, to disclose information for the issuer as a whole regarding:

(a) general information (in particular factors used to identify the entity's reportable segments);

(b) products and services from which each reportable segment derives its revenues;

(c) geographical areas; and

(d) major customers.

This requirement applies, regardless of the issuer's organisation, if the information is not included as part of the disclosures about segments.

IAASA has observed that a number of issuers which have indicated that they have a single operating segment have failed to provide the entity-wide disclosures required by paragraphs 31 to 34 of IFRS 8.

IFRS 8 makes reference to *'external customers*' and '*major customers'*. While fund and debt issuers may not have *'customers'* in the conventional sense, it is IAASA's expectation that these types of issuers would provide equivalent minimum entity-wide disclosures as described in paragraphs 22 and 31 to 34 of IFRS 8. It is, furthermore, IAASA's expectation that the quality of disclosures provided in this regard – and, in particular, by fund and debt issuers – will be enhanced in future periodic financial statements.

8. IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*[31]

The objective of IAS 37 is to ensure that appropriate recognition criteria and measurement bases are applied to provisions, contingent liabilities and contingent assets and that sufficient information is disclosed in the financial statements to enable users to understand their nature, timing and amount. Paragraphs 84, 85 and 86 of IAS 37 require the disclosure of certain information for '*each class*' of provision and paragraph 87 provides guidance as to what constitutes a '*class*'[32].

IAASA has observed instances in which issuers have aggregated provisions into a single class where the nature of the provisions was not sufficiently similar to meet the requirements for aggregation. . Furthermore, instances have been observed where disclosure of the expected timing of future outflows has not been provided.

It is IAASA's expectation that Boards and Audit Committees will carefully consider these matters with a view to ensuring that sufficient information is disclosed in the financial statements to enable users to understand the nature, timing and amount of each separate class of provisions or indeed any individually material provision.

9. Restatement and reclassification of amounts

Paragraph 41 of IAS 1 *Presentation of Financial Statements* states that:

> '*When the entity changes the presentation or classification of items in its financial statements, the entity shall reclassify comparative amounts unless reclassification is impracticable. When the entity reclassifies comparative amounts, the entity shall disclose:*

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[30] '*Operating matters*' refers to information used to make decisions about resources to be allocated to segments and assess segment performance; paragraph 5 of IFRS 8 refers

[31] For Irish GAAP issuers, FRS 12 *Provisions, contingent liabilities and contingent assets* is the relevant Standard

[32] '*In determining which provisions or contingent liabilities may be aggregated to form a class, it is necessary to consider whether the nature of the items is sufficiently similar for a single statement about them to fulfil the requirements of paragraphs 85(a) and (b) and 86(a) and (b). Thus, it may be appropriate to treat as a single class of provision amounts relating to warranties of different products, but it would not be appropriate to treat as a single class amounts relating to normal warranties and amounts that are subject to legal proceedings.*'

(a) the nature of the reclassification;

(b) the amount of each item or class of items that is reclassified; and

(c) the reason for the reclassification.'

IAASA has observed that certain issuers reclassify comparative amounts without providing information regarding the nature, amount and/or reason for such reclassifications. It is also IAASA's expectation that, where an issuer effects restatements and/or reclassifications of items, the disclosures required by IAS 1 will be provided. It is, similarly, IAASA's expectation that, where comparative amounts are reclassified, the disclosures mandated by paragraph 41 will be provided.

10. Limited recourse debt issuers: risk disclosures

It was noted in IAASA's 2010 *Observations* document that, notwithstanding the structure of limited recourse debt issuers (i.e. profit neutral with gains and losses on investments being offset by losses and gains on the related series of notes), such issuers are not exempt from the risk disclosure requirements of IFRS 7. While the structure and operation of each series of notes issued by limited recourse debt entities is determined at inception, nevertheless, the objectives of paragraph 1 of IFRS 7 apply equally to limited recourse debt issuers i.e. to provide disclosures sufficient to enable users to evaluate the nature and extent of risks arising from financial instruments.

During 2010, IAASA undertook an examination of a sample of such issuers' financial reports in order to determine the level of compliance, or otherwise, with the risk disclosure requirements of IFRS 7/FRS 29. Based on that examination, the observations and key messages arising included:

(a) noteholders are a key user of the financial reports of limited recourse debt issuers, being, in most instances, the principal providers of finance to such issuers. However, issuers' perceptions of who could reasonably be considered to be the '*users*' of limited recourse debt issuers' financial statements may be too narrow. As a result, the usefulness of the risk disclosures provided by many limited recourse debt issuers has tended to be boilerplate, minimal and, in the majority of reports reviewed by IAASA, lacking other price risk and counterparty risk disclosures. The aforementioned review activity resulted in a number of issuers undertaking to enhance their risk disclosures in future periodic reports;

(b) depending on the use, or otherwise, of derivative financial instruments to mitigate some/all of the risks, notes may effectively behave as pass-through securities (i.e. the risk of the underlying investments is passed directly to the noteholder) or, the noteholders may hedge some/all of the interest rate risk, or currency risk and be left with the underlying other price risk, with derivative counterparties sharing the risks. For derivative linked notes, derivative counterparty risk remains, therefore, an important risk disclosure;

(c) meaningful and comprehensive risk disclosures are those which clearly communicate the principal risks to noteholders, together with changes, if any, in those risks that have occurred during the period and should reflect differences in risks between different series of notes. The nature and detail of risk disclosure remains a matter for the directors to decide, with the basis for the risk disclosures being that which is necessary for a proper understanding of the relevant events, transactions and other factors, judged appropriate to the particular circumstances.

11. IAS 34 *Interim Financial Reporting*

Paragraph 16 of IAS 34 sets out the minimum requirements that an issuer is required to comply with in its half-yearly financial statements. These requirements include the requirement to disclose:

(a) any events or transactions that are material to an understanding of the current half-year period; and

(b) the nature and amount of items affecting assets, liabilities, equity, net income or cash flows that are unusual because of their nature, size or incidence.

In its examination of half yearly financial reports, IAASA has observed instances in which issuers have failed to disclose information regarding significant movements in balance sheet items.

In the current economic environment, where there may be significant movements in balance sheet captions as issuers re-focus their activities or as asset and liability valuations fluctuate, it is IAASA's expectation that more extensive disclosures in half-yearly financial reports will be provided in users' interests.

Boards and Audit Committees should avoid the temptation to adopt a '*same as last year*' approach to half-yearly reports where such an approach is inappropriate from the perspective of user interests. Given that there is no requirement for auditor involvement in half-yearly financial reports, the necessity for Boards and Audit Committees to devote additional attention to ensuring the provision to users of decision useful information in this regard is all the greater.

12. New legislation and accounting pronouncements applicable for 2010 year end reports

12.1 IFRS 3 Business Combinations (2008)

IFRS 3 (Revised) replaces IFRS 3 (2004) and comes into effect for business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after 1 July, 2009. Earlier application is permitted, provided that IAS 27[33] (2008) is applied at the same time. Consequently, for the majority of issuers, IFRS 3 (2008) is mandatory for 2010 financial year ends.

Significant features of the revised Standard include:

(a) on the date that control is obtained, the fair values of the acquired entity's assets and liabilities, including goodwill, are measured (with the option to measure full goodwill or only the acquirer's percentage of goodwill). Any resulting adjustments to previously recognised assets and liabilities are recognised in profit or loss;

(b) consideration for the acquisition includes the acquisition-date fair value of contingent consideration. Changes to contingent consideration resulting from events after the acquisition date must be recognised in profit or loss; and

(c) costs associated with the acquisition, e.g. finder's fees, advisory, legal, accounting, valuation and other professional or consulting fees and general administrative costs, including the costs of maintaining an internal acquisitions department, must be expensed, including reimbursements to the acquiree for bearing some of the acquisition costs.

As a result, there may be increased volatility in reported earnings for issuers with significant acquisition activity.

Paragraphs 50 to 63 and B64 to 67 of IFRS 3 set out the disclosure requirements. Importantly, the disclosure requirements apply equally to half-yearly financial statements by virtue of the application of paragraph 16(i)[34] of IAS 34 *Interim Financial Reporting*[35] and IAASA has noted that affected issuers do not always provide the required disclosures in their half-yearly financial reports. Consequently, IAASA has had to require issuers to do so in the past.

IAASA has also noted that affected issuers tend to present acquisition-related costs as exceptional costs irrespective of the particular circumstances applying to the issuer and the acquisition(s) in question. It is IAASA's expectation that acquisition-related costs incurred by acquisitive issuers would not necessarily be classified as exceptional costs.

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[33] IAS 27 *Consolidated and Separate Financial Statements*

[34] Paragraph 16(i) of IAS 34: '*the effect of changes in the composition of the entity during the interim period, including business combinations, obtaining or losing control of subsidiaries and long-term investments, restructurings, and discontinued operations. In the case of business combinations, the entity shall disclose the information required by IFRS 3* Business Combinations'. Consequent on Improvements *to IFRSs* (issued May 2010), effective 1 January, 2011, paragraph 16(i) was replaced by paragraph 16A(i)

[35] ASB Statement *Half-yearly financial reports* is the applicable pronouncement for Irish GAAP issues

In addition to examining disclosures in half-yearly financial reports, it is likely that IAASA's future financial statement review activity will include a focus on:

(a) the accounting treatment of acquisition-related costs;

(b) the rationale underlying the classification of such costs as exceptional; and

(c) the accounting treatment applied in respect of aborted acquisitions.

12.2 IAS 24 Related Party Disclosures *(revised)*[36]

IAS 24[37] (Revised) amends the disclosure requirements for Government-related entities and clarifies the definition of a related party. The revised Standard is effective for annual periods beginning on or after 1 January, 2011, with earlier application permitted.

IAS 24 requires entities to disclose in their financial statements information about transactions with related parties. In broad terms, two parties are related to each other if one party controls, or significantly influences, the other party.

The revised Standard makes the following amendments, amongst others:

(a) the provision of a partial exemption for Government-related entities – under the previous requirements of IAS 24, if a Government controlled, or significantly influenced, an entity, the entity was required to disclose information about all transactions with other entities controlled, or significantly influenced, by the same Government. The revised IAS continues to require disclosures that are important to users of financial statements but eliminates requirements to disclose information that is costly to gather and of less value to users. It achieves this balance by requiring disclosure about these transactions only if they are individually or collectively significant; and

(b) providing a revised definition of '*related party*' – the IASB has simplified the definition and removed inconsistencies.

It is likely that the provisions of IAS 24 (revised) will have particular significance for financial institutions under State control or with significant State influence and that such issuers will avail of the exemption in paragraph 25 of IAS 24 (revised) from disclosing related party transactions and outstanding balances, including commitments, with a Government that has control, joint control or significant influence over the issuer. IAASA has observed that issuers have interpreted the term '*Government*' very differently and, within that definition, provided different levels of related party disclosure.

Affected issuers are reminded that when applying this exemption, the issuer shall nonetheless disclose the following about the transactions and related outstanding balances:

(a) the name of the Government and the nature of its relationship with the reporting entity (i.e. control, joint control or significant influence);

(b) the following information in sufficient detail to enable users of the issuer's financial statements to understand the effect of related party transactions on its financial statements:

   (i) the nature and amount of each individually significant transaction; and

   (ii) for other transactions that are collectively, but not individually, significant, a qualitative or quantitative indication of their extent.

IAS 24 (revised) defines '*Government*' as '...*government, government agencies and similar bodies whether local, national or international*'.

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[36] FRS 8 *Related party disclosures* is the applicable Standard for Irish GAAP issuers

[37] IAS 24 *Related Party Disclosures*

It is IAASA's expectation that affected issuers will provide disclosures with regard to how they have applied this definition in sufficient detail to enable users of the issuer's financial statements to understand the impact that transactions and balances, including commitments, with Government may have affected the issuer's financial position and profit or loss.

12.3 Disclosure of auditors' remuneration

In May 2010, the Minister for Enterprise, Trade & Innovation signed the European Communities (Statutory Audits) (Directive 2006/43/EC) Regulations 2010[38] ('the SAD Regulations') into law. IAASA has recently issued a Guide to the SAD Regulations, which can be obtained on the IAASA website[39].

The SAD Regulations contain provisions applicable to certain issuers regarding disclosures relating to the remuneration in respect of all work carried out by the auditor[40]. This disclosure is to be made separately in respect of each of the following categories of work:

(a) the audit of individual accounts;

(b) other assurance services;

(c) tax advisory services; and

(d) other non-audit services.

There are certain exemptions for certain classes of companies.

The required disclosures are effective for financial years ending on or after 20 August, 2010 and, consequently, are applicable for 31 December, 2010 reporting dates.

12.4 Corporate governance disclosures (S.I. No. 450)

The European Communities (Directive 2006/46/EC) Regulations 2009 (S.I. No. 450 of 2009)[41] as amended by the European Communities (Directive 2006/46/EC) (Amendment) Regulations 2010[42] gave effect to new financial reporting and corporate governance disclosure requirements, including a requirement for certain entities to make a Corporate Governance Statement - including identifying the particular code applied and commenting on the extent of compliance – which applies to accounting periods which end or after 18 November, 2009. However, the requirement to include a description of risk management and internal controls over the financial reporting process applies to periods beginning on or after 18 November, 2009. The application of the above requirements as regards fund issuers applies to periods beginning on or after 18 November, 2009.

Consequently, the requirements are applicable for 31 December, 2010 reporting dates.

12.5 IFRIC[43, 44] changes

12.5.1 IFRIC Interpretation 17: Distributions of Non-cash Assets to Owners

This IFRIC Interpretation provides guidance on how an issuer should measure distributions to its owners. The Interpretation states that:

(a) the liability to pay a dividend shall be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity;

(b) the entity shall measure a liability to distribute non-cash assets as a dividend to its owners at the fair value of the assets to be distributed; and

[38] Available at http://www.iaasa.ie/legislation/si220_2010.pdf
[39] http://www.iaasa.ie/publications/Guide_8thDirective2011.pdf
[40] Regulation 120 of the SAD Regulations
[41] Available at http://www.iaasa.ie/legislation/si450_2009.pdf
[42] Available at http://www.iaasa.ie/legislation/si83_2010.pdf
[43] International Financial Reporting Interpretations Committee Interpretation
[44] Urgent Issues Task Force ('UITF') Abstracts for Irish GAAP issuers

(c) when an entity settles the dividend payable, it shall recognise the difference, if any, between the carrying amount of the assets distributed and the carrying amount of the dividend payable in profit or loss.

An issuer shall apply IFRIC 17 prospectively for annual periods beginning on or after 1 July, 2009.

12.5.2 IFRIC Interpretation 19: Extinguishing financial liabilities with equity instruments[45]
A debtor and creditor might re-negotiate the terms of a financial liability with the result that the debtor extinguishes the liability fully or partially by issuing equity instruments to the creditor. These transactions are sometimes referred to as 'debt for equity swaps'. This Interpretation provides guidance on the accounting for such transactions and states that:

(a) the issue of an entity's equity instruments to a creditor to extinguish all or part of a financial liability is consideration paid in accordance with paragraph 41 of IAS 39. An entity shall remove a financial liability (or part of a financial liability) from its statement of financial position when, and only when, it is extinguished in accordance with paragraph 39 of IAS 39;

(b) when equity instruments issued to a creditor to extinguish all or part of a financial liability are recognised initially, an entity shall measure them at the fair value of the equity instruments issued, unless that fair value cannot be reliably measured; and

(c) if the fair value of the equity instruments issued cannot be reliably measured then the equity instruments shall be measured to reflect the fair value of the financial liability extinguished.

IFRIC Interpretation 19 is applicable for annual periods beginning on or after 1 July, 2010. Earlier application is permitted.

Irish Auditing & Accounting Supervisory Authority
24 January, 2011

[45] UITF Abstract 47 *(IFRIC Interpretation 19) Extinguishing Financial Liabilities with Equity Instruments* for Irish GAAP issuers

GLOSSARY OF TERMS

ASB	Accounting Standards Board
EEA	European Economic Area
EPS	Earnings Per Share
EU	European Union
FRS	Financial Reporting Standard
GAAP	Generally Accepted Accounting Principles
IAASA	Irish Auditing & Accounting Supervisory Authority
IAS	International Accounting Standard
IASB	International Accounting Standards Board
IFRIC	International Financial Reporting Interpretations Committee
IFRS	International Financial Reporting Standard
IMF	International Monetary Fund
KMP	Key Management Personnel
Regulations	Transparency (Directive 2004/109/EC) Regulations 2007 (S.I. No. 277 of 2007)
SAD Regulations	European Communities (Statutory Audits) (Directive 2006/43/EC) Regulations 2010 ('Statutory Audit Directive') (S.I. No. 220 of 2010)
SSAP	Statement of Standard Accounting Practice
Transparency Rules	Financial Regulator Transparency Rules, September 2009
UITF	Urgent Issues Task Force