



OBSERVATIONS ON SELECTED FINANCIAL REPORTING ISSUES

**ISSUERS' FINANCIAL YEARS ENDING ON OR
AFTER 31 DECEMBER, 2011**

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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INTRODUCTION

1. Overview

1.1 *Financial statement review remit*

Since commencing its financial reporting review activities under the Transparency (Directive 2004/109/EC) Regulations 2007 (S.I. No. 277 of 2007) ('the Regulations')¹, the Irish Auditing and Accounting Supervisory Authority ('IAASA') has examined annual and/or half-yearly financial reports of a significant proportion of the equity, debt and fund issuers falling under its remit.

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 GAAP² issuers'). Therefore, although IAASA's review activity extends to periodic financial reports prepared under other codes of accounting standards (e.g. US GAAP), the observations offered in this document are limited to the requirements as they apply to IFRS and Irish GAAP issuers.

The matters raised in the document derive from the outcome of IAASA's examinations conducted in 2011 together with IAASA's expectations of issuers for 2011 year ends.

1.2 *Economic environment*

Data for the Irish economy provides indications of modest increases in GNP and GDP. The export sector continues to be a key driver of economic recovery. However, domestic consumer sentiment remains fragile with weak consumer demand presenting a challenge to many issuers. This, in combination with an uncertain global outlook has led to some downward adjustments to growth forecasts for 2012.

The second half of 2011 has witnessed heightened concerns regarding the eurozone and a lowering of forecasts for economic growth in the eurozone, the UK and most of Ireland's major trading markets. Policy measures by the relevant authorities are likely to see lower eurozone and UK interest rates for a longer period than anticipated earlier in the year. Trading conditions remain challenging for many issuers, in particular issuers relying on the Irish domestic market.

1.3 *Impact on financial reporting environment*

This economic backdrop results in ongoing risk and uncertainty in the recognition, measurement and classification of revenues, expenses, assets and liabilities in financial statements in respect of financial years ending on or after 31 December, 2011 as well as to associated risks in the context of presentation and disclosure.

This ongoing risk and uncertainty highlights the critical importance of the estimates and judgments made by issuers' management and Boards and Audit Committees in preparing financial reports and in ensuring appropriate disclosures are provided to users of those financial reports in respect of those estimates and judgments.

The importance of the role played by Boards and Audit Committees in considering and approving issuers' periodic financial reports, as prepared on the directors' behalf by management, is all the more important in such challenging circumstances.

Areas that are subject to significant uncertainty and, therefore, have the potential to significantly affect amounts recognised and disclosures provided in financial statements include:

- (a) assessment of the carrying amount of classes of assets, including intangible assets (e.g. internally generated assets, intangible assets acquired and goodwill), tangible fixed assets and accounts receivable;
- (b) deferred tax assets;

¹ Available at http://www.iaasa.ie/legislation/si277_2007.htm

² Generally Accepted Accounting Principles

- (c) provisions, including, but not limited to, restructuring provisions;
- (d) measurement of the fair value of financial instruments;
- (e) measurement of retirement benefit obligations;
- (f) availability of adequate funding and going concern considerations; and
- (g) key assumptions made about the future.

Risks and uncertainties associated with the euro are addressed at item 5 on pages 12 and 13 and the financial reporting implications of the sovereign debt crisis are addressed at item 9 on pages 15 and 16.

2. Purpose of this document

In common with previously published Observations documents³, the purpose of this document is twofold, namely to:

- (a) seek to assist issuers' management and those charged with issuers' governance in the preparation of high quality financial reports by offering observations on selected financial reporting issues to coincide with the preparation of issuers' 2011 financial statements; and
- (b) provide issuers' management, 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 2012.

The audience for this document is principally intended to be those involved in the preparation, approval and/or review of issuers' financial reports, including, issuers' management, Audit Committees and Boards, providers of audit and other assurance services, legal advisors, listing agents and, where applicable, fund administrators and/or other relevant service providers. In that context, IAASA encourages the widest possible transmission of this document.

3. 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 Reports⁴;
- (b) the IAASA document entitled *Observations on Materiality in Financial Reporting*⁵;
- (c) the IAASA *Commentary* on issuers' half yearly financial reporting⁶;
- (d) periodically published summaries of enforcement decisions taken by EU financial reporting supervisory authorities⁷, the tenth and eleventh extracts of which were published during 2011⁸; and

³ *Observations on selected financial reporting issues – issuers' financial years ending on or after 31 December, 2010*, available at http://www.iaasa.ie/publications/Obsdoc_Jan11.pdf;

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

⁴ These Annual Reports are available at <http://www.iaasa.ie/publications/index.htm>

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

⁶ Available at http://www.iaasa.ie/publications/TD_Commentary2008.pdf

⁷ These summaries can be accessed at <http://www.iaasa.ie/publications/index.htm> in the 'Third-party Publications' section

⁸ Available at <http://www.iaasa.ie/publications/index.htm> and on the ESMA website at http://www.esma.europa.eu/system/files/2011_62.pdf and http://www.esma.europa.eu/system/files/2011_265.pdf

- (e) the annual activity reports published by the European Securities and Markets Authority ('ESMA') on monitoring enforcement of IFRS in Europe⁹.

Furthermore, it is expected that IAASA will publish the findings of a survey of the quality of the risk and fair value disclosures in the annual financial reports of selected Debt and Fund issuers early in 2012 and readers may wish to refer to that document when published.

4. Reader feedback

This is the fourth annual *Observations* document published by IAASA.

If readers have views on the usefulness of this document or suggestions as to how it might be enhanced to meet their specific requirements, IAASA would welcome stakeholder feedback, which can be provided to info@iaasa.ie or by telephone at +353 (0)45 983600.

This invitation to readers to provide feedback is part of a wider initiative by IAASA to seek feedback from stakeholders on IAASA's financial reporting review activity. This feedback initiative is being undertaken at this time given that IAASA has been interacting with issuers since 2007 and has now corresponded with the significant majority of issuers falling within its financial statement review remit. In that context, IAASA considers it opportune to seek views from relevant parties about its financial reporting review activity.

⁹ Available at <http://www.iaasa.ie/publications/index.htm> and on the ESMA website at http://www.esma.europa.eu/system/files/2011_355.pdf

OBSERVATIONS ON SELECTED FINANCIAL REPORTING ISSUES

1. Continued applicability of matters raised in previous Observations documents

As referred to earlier in this document, IAASA has published *Observations* documents in the years 2009 – 2011. These documents are available on IAASA's website¹⁰.

Certain of the issues referred to in those earlier years' documents are of continuing applicability and, consequently, readers may find it helpful to read this document in conjunction with those earlier documents. In that context, readers' attention is drawn in particular to the following matters raised in those earlier documents and which, in IAASA's view, continue to be relevant to 2011 reporting dates.

1.1 Impairment of non-financial assets/intangible assets

IAS¹¹ 36 *Impairment of Assets* requires that the discount rate applied to estimated future cash flows shall be a pre-tax rate that reflects risks specific to the asset for which the future cash flow estimates have not been adjusted¹². In the context of the economic backdrop, depressed asset prices and other risk factors, this issue is of continuing relevance to the 2011 reporting season. Readers' attention is, therefore, drawn to section 2 of the 2010 *Observations* document¹³.

1.2 Operating segments

IFRS 8 *Operating Segments*¹⁴ requires an issuer, including an issuer with a single reportable segment, to disclose specified information for the issuer as a whole.

In light of IAASA's findings in this regard this issue is of continuing relevance. Readers' attention is, therefore, drawn to the 2009 *Observations* document¹⁵.

1.3 Employee benefits – discount rates

IAS 19 *Employee Benefits*¹⁶ provides that 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 on high quality corporate bonds at the end of the reporting period.

In the context of the significance of the rate used in measuring pension obligations, readers' attention is drawn to the 2010 *Observations* document¹⁷.

1.4 Re-classifications

IAS 1 *Presentation of Financial Statements* sets out the requirements when an issuer changes the presentation or classification of items in its financial statements (IAS 1.41)¹⁸.

It is IAASA's expectation that, in circumstances where an issuer changes the presentation or classification of items in its financial statements, the issuer will provide the required disclosures. IAASA continues to identify instances where issuers have re-classified comparative items without explaining or inadequately explaining the nature, amount and reason therefor.

1.5 Fair value measurements

In the context of continuing market turmoil, the determination of the fair value of financial instruments remains a significant financial reporting consideration for certain issuers. In that context, readers' attention is drawn to:

¹⁰ *Observations on selected financial reporting issues – issuers' financial years ending on or after 31 December, 2010*, available at http://www.iaasa.ie/publications/Obsdoc_Jan11.pdf;
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

¹¹ International Accounting Standard

¹² IAS 36.55. Financial Reporting Standard ('FRS') 11 *Impairment of fixed assets and goodwill* contains broadly similar requirements for Irish GAAP issuers (FRS 11.41 refers)

¹³ Pages 14 of IAASA's 2010 *Observations* document refers

¹⁴ Statement of Standard Accounting Practice ('SSAP') 25 *Segmental reporting* is the relevant accounting pronouncement for Irish GAAP issuers

¹⁵ Section 2.13.2 on page 17 of IAASA's 2009 *Observations* document refers

¹⁶ For issuers applying Irish GAAP, FRS 17 *Retirement benefits* is the relevant accounting pronouncement

¹⁷ Section 3 on page 14 of IAASA's 2010 *Observations* document refers

¹⁸ FRS 28 *Corresponding amounts* is the relevant accounting pronouncement for Irish GAAP issuers

- IFRS 13 *Fair Value Measurement*, which, while not yet EU endorsed, establishes a single source of guidance for fair value measurement under IFRS (see item 15.6 below); and
- IAASA's 2010 *Observations* document¹⁹.

1.6 Overall quality of financial reporting

In preparing their periodic financial reports, issuers sometimes present information over and above the requirements of accounting standards and company law in order to provide users with additional information considered relevant to their needs. In that context, readers' attention is drawn to:

- the general comments included in IAASA's 2010 *Observations* document²⁰; and
- IAASA's 2009 *Observations* document dealing with the use of a line item '*operating profit*'²¹; and
- IAASA's 2009 *Observations* document dealing with non-GAAP measures of performance and key performance indicators²².

2. Employee benefits – amendments to employee benefit plans

Given the risks attaching to defined benefit plans, many businesses are examining the terms of their employee pension arrangements resulting in amendments to and consequently, in certain instances, significant reductions in defined benefit obligations being recognised in the Statement of Financial Position.

In determining the appropriate financial reporting treatment to be applied in such instances, the attention of Boards and Audit Committees is drawn to the following:

- an issuer accounts not only for its legal obligations under the formal terms of a defined benefit plan but also for any constructive obligations that arise from the issuer's informal practices (IAS 19.52–53 and FRS 17.37²³); and
- the requirements for accounting for settlements and curtailments (IAS 19.100–115 and FRS 17.64–66)).

In addition, the attention of Boards and Audit Committees is drawn to the requirements of IAS 1.112 which states that '*The notes [to the financial statements] shall ... provide information that is not presented elsewhere in the financial statements, but is relevant to an understanding of any of them.*'

IAASA has noted instances where the information provided regarding amendments to defined benefit pension plans has been too limited in nature to provide an adequate understanding of the financial position, financial performance and cash flows of the issuer.

3. Provisions

1.7 Disclosures

The objective of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*²⁴ 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 notes to the financial statements to enable users to understand their nature, timing and amount.

¹⁹ Item 1.2 on page 12 of IAASA's 2010 *Observations* document refers

²⁰ Item 2 on pages 5 to 8 of IAASA's 2010 *Observations* document refers

²¹ Item 2.8 on page 13 of IAASA's 2009 *Observations* document refers

²² Item 2.9 on pages 13 and 14 of IAASA's 2009 *Observations* document refers

²³ FRS 17 *Retirement benefits*

²⁴ FRS 12 *Provisions, contingent liabilities and assets*, the relevant accounting pronouncement for Irish GAAP issuers, contains no differences of substance with IAS 37

The principle underpinning IAS 37 is that a provision is recognised when and only when there is a present obligation as a result of a past event (IAS 37.14).

When the provision involves a large population of items (e.g. warranty claims for homogenous products) the obligation is measured at its '*expected value*' (IAS 37.39).

During 2011, IAASA corresponded with a number of issuers regarding the recognition, measurement and disclosures surrounding provisions.

The attention of Boards and Audit Committees is drawn, in particular, to the following aspects of IAS 37:

- (a) '*A provision is recognised when ... an entity has a present obligation (legal or constructive) as a result of a past event*' (IAS 37.14(a)). Both conditions must be met for a provision to be recognised. IAS 37.15–22 set out the factors to be considered in determining whether a provision should be recognised;
- (b) IAS 37.63 prohibits the recognition of a provision for future operating losses;
- (c) IAS 37.84–85 set out the disclosures required for each '*class*' of provision. IAS 37.87 provides guidance as to what constitutes a '*class*' of provision; and
- (d) IAS 37.92 exempts, in extremely rare cases, the disclosure of information that would '*prejudice seriously the position of the entity*'. However, even in such cases, the issuer is required to disclose:
 - (i) the general nature of the dispute; and
 - (ii) the fact that, and the reason why, the information has not been disclosed.

1.8 Restructuring provisions

IAS 37.70–83 and FRS 12.75–88 set out the requirements with regard to the recognition and measurement of restructuring provisions. A provision for restructuring costs is recognised only when the general recognition criteria for provisions are met. Aspects of IAS 37's requirements include:

- (a) closure or reorganisation: accrue only after a detailed formal plan is adopted and announced publicly. A decision by the Board is not, of itself, sufficient (IAS 37.75);
- (b) future operating losses: provisions should not be recognised for future operating losses, even in a restructuring (IAS 37.82); and
- (c) restructuring provisions should include only direct expenditures caused by the restructuring, not costs that are associated with the ongoing activities of the entity (IAS 37.80–82).

4. Risks and uncertainties

The Regulations require that:

- (a) an issuer's annual financial report shall include a management report. That report must be balanced and provide a comprehensive analysis – using key performance indicators ('KPIs') – of the development and performance of the business during the year and the position of the business at year end, consistent with the issuer's size and complexity (Regulation 5(3)); and
- (b) in respect of half-yearly financial reports, '*The interim management report shall include at least:*
 - (a) *an indication of important events that have occurred during the first 6 months of the financial year, and their impact on the condensed set of financial statements, and*

- (b) a description of the principal risks and uncertainties for the remaining 6 months of the financial year' (Regulation 8(2)).

In this regard, IAASA has found, during the course of its examinations of issuers' periodic financial reports, that:

- (a) certain issuers provide disclosures that appear to be 'boiler plate' in nature and, therefore, provide limited, if any, decision useful information to users;
- (b) the information provided can sometimes focus almost exclusively on 'good news' rather than presenting a balanced view of the issuer's development and performance during the period; and
- (c) the management report can sometimes omit an analysis of the strategy being pursued by the issuer, any changes thereto and the significant activities underway to achieve that strategy.

Issuers' periodic reports comprise the periodic financial statements and accompanying management commentary. In undertaking its reviews of financial statements under the Regulations, IAASA studies the accompanying commentary to inform itself as to activities undertaken by the issuer during the period. In instances where significant events and transactions are described in those accompanying commentaries, IAASA may request additional information and explanations from issuers where it appears that the associated financial reporting treatment appears not to be consistent with the commentary.

In that regard, Boards and Audit Committees are reminded of the requirements of the Regulations that the management report shall provide a balanced and comprehensive review of the development of the business in the period.

IAASA has identified instances where matters are stated to be key risks facing an issuer but the related financial reporting treatment is not consistent with that risk (e.g. the cyclical nature of an issuer's business is identified as a key risk facing that issuer in the management report but in its half-yearly financial report the issuer omits disclosure regarding the seasonality or cyclicity of interim operations (IAS 34.16A(b)²⁵ refers²⁶)).

Liability management exercises and related financial reporting considerations

In 2011, the continuation and severity of the financial crisis has meant that many issuers have experienced weakened demand for their products and services, liquidity risks have increased, the availability of finance has decreased, the cost of finance has increased and certain issuers' ability to achieve forecast cash flows has been called into question. In addition, the inability of certain issuers to roll over existing finance or raise new finance has raised doubts as to the sustainability of those entities' debt levels.

Mindful of the foregoing, certain financial institutions and equity issuers have undertaken or may be planning to undertake so called 'liability management exercises' in order to improve the sustainability of their financing structures.

These exercises may include:

- (a) an exchange between an existing borrower and lender of debt instruments with substantially different terms; or
- (b) a substantial modification of the terms of an existing financial liability or part of it.

The requirements governing the derecognition of a financial liability are described in IAS 39.17²⁷, 18, 20 and 21. The requirements governing the creation/transfer of a financial liability are described in

²⁵ IAS 34 *Interim Financial Reporting*

²⁶ Paragraph 18 of the ASB's *Statement: Half-yearly financial reports* refers

²⁷ IAS 39 *Financial Instruments: Recognition and Measurement*

IAS 39.20(a) and 25 together with the recognition of gains/losses arising on transfer (IAS 39.26 and 41).²⁸

In addition, IAS 39.39 states that:

'An entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when, and only when, it is extinguished – i.e. when the obligation specified in the contract is discharged or cancelled or expires.'

IAS 39.40 states that:

'An exchange between an existing borrower and lender of debt instruments with substantially different terms shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability. Similarly, a substantial modification of the terms of an existing financial liability or a part of it (whether or not attributable to the financial difficulty of the debtor) shall be accounted for as an extinguishment of the original financial liability and the recognition of a new financial liability.'

IAS 39.41 states that:

'The difference between the carrying amount of a financial liability (or part of a financial liability) extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.'

In that regard, Boards and Audit Committees are reminded of the accounting treatment prescribed in IAS 39 (i.e. when it is appropriate to derecognise a financial liability and the recognition of a new financial liability together with the recognition of a gain/loss in the Statement of Comprehensive Income and the disclosures necessary to explain the nature of the debt exchange, the significant terms of the transaction and the impact on the financial position).

5. Risk disclosures – the euro

In assessing the principal risks and uncertainties facing an issuer, and in determining the appropriate disclosures to provide regarding the assumptions it makes about the future and other major sources of estimation uncertainty, risks associated with the future of the euro as a currency bloc need to be evaluated. Such risks may include:

- (a) uncertainty in the market may result in weak consumer demand for the issuer's products and services. This risk may also adversely impact on cash flow projections and forecasts used to assess impairments of assets;
- (b) foreign exchange exposures associated with a return to national currencies;
- (c) disruption to normal trading terms and cash flows in the event that the banking system were unable to respond to the re-introduction of national currencies in a timely and comprehensive manner;
- (d) the impact on short term and long term interest rates;
- (e) the need for issuers to re-assess their functional and presentation currencies;
- (f) the impact of resultant uncertainties in input and output prices; and
- (g) changes to the geo-political balances in Europe and further afield, and the risk of social disruption in the event of a disorderly collapse of the euro as a currency.

²⁸ For Irish GAAP issuers, FRS 26 (IAS 39) *Financial Instruments: Recognition and Measurement* is the relevant accounting pronouncement

While contingency planning in this regard is a matter for Boards generally, in the context of financial reporting, Boards and Audit Committees are expected to consider the appropriate level of disclosure in this regard in their 2011 financial reports.

6. Risk disclosures – fund and debt issuers

IFRS 7 requires issuers to provide disclosures that enable users to evaluate the significance of financial instruments 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 and how the issuer manages those risks (IFRS 7.1).

While of particular applicability to Debt and Fund issuers, the requirements of IFRS 7 apply, with certain specified exceptions, to all issuers and to all types of financial instruments.

As mentioned earlier, it is expected that IAASA will publish the findings of a survey of the quality of the risk and fair value disclosures in the annual financial reports of selected Debt and Fund issuers early in 2012 and attention is drawn to that publication.

7. Recoverable amount of assets/Cash Generating Units ('CGUs')

The objective of IAS 36 is to prescribe the procedures that an issuer applies to ensure that assets are carried at no more than their recoverable amount. In this context, 'assets' may refer to an individual asset or an individual CGU.

Where the recoverable amount of an asset is its value in use ('VIU'), IAS 36.30 outlines the factors that shall be reflected in the calculation of an asset's VIU including:

- (a) estimates of future cash flows and expectations about possible variations in the amount or timing of those future cash flows;
- (b) the time value of money;
- (c) the price for bearing the uncertainty inherent in the asset; and
- (d) other factors such as illiquidity that market participants would reflect in pricing future cash flows the entity expects to derive from the asset.

IAS 36.34 states that:

'Management assesses the reasonableness of the assumptions on which its current cash flow projections are based by examining the causes of differences between past cash flow projections and actual cash flows...'

IAS 36.38 states:

'In using information from financial budgets/forecasts, an entity considers whether the information reflects reasonable and supportable assumptions and represents management's best estimate of the set of economic conditions that will exist over the remaining useful life of the asset'.

In a number of cases IAASA has observed that the key assumptions underpinning an issuer's VIU calculations had either changed significantly without an explanation for the rationale for that change or the circumstances of the entity suggested there were doubts as to the methodology used to measure the recoverable amount of a CGU or the sensitivity of the reported headroom in CGUs. As a consequence, certain issuers undertook to provide more detailed disclosures in future financial reports as to any changes in key assumptions and/or the methodology used to measure the VIU of CGUs.

Where an issuer has material CGU(s) containing goodwill or intangible assets with indefinite useful lives, Boards and Audit Committees should scrutinise the methodology used to determine the VIU

attributed to assets/CGUs, the key assumptions underpinning the calculations and forecasts, and the changes therein, during the period.

In examining the appropriateness of the recoverable amounts attributed to intangible assets/CGUs for each material asset/CGU, IAASA considers a number of considerations including but not limited to:

- (a) the methodology used to calculate the VIU and any changes therein during the period and the reasons for changes;
- (b) the detailed workings of the cash flow forecasts, by each material asset/CGU (rather than aggregated data);
- (c) the robustness of the cash flow forecasts to sensitivities in reasonably possible changes (both amount and timing of cash flows and the key assumptions underpinning the forecasts);
- (d) the assumptions underpinning the VIU calculations (e.g. earnings growth, cost growth, gross margin/markup, discount rate applied to cash flows, variability in the amount or timing of cash flows) together with an explanation of any changes therein during the period and the reasons for such changes; and
- (e) the identification of the KPIs, whether these KPIs have been met in the past together with whether and how future KPIs reflected in the forecast cash flows have been adjusted for future circumstances.

8. Tax risks and uncertainties

Issuers, including those with operations dependent on Irish consumer spending, may have accumulated substantial tax losses in the past number of years. The recovery of such tax losses may be dependent on future taxable profits arising in the same taxable entities and/or on the successful implementation of tax planning opportunities.

IAS 12 *Income Taxes*²⁹ requires disclosure of '*the amount (and expiry date, if any) of deductible temporary differences, unused tax losses and unused tax credits for which no deferred tax asset is recognised in the statement of financial position*' (IAS 12.81(e)).

IAS 1 requires an entity to disclose '*... information about the assumptions it makes about the future, and other major sources of estimation uncertainty at the end of the reporting period that have a significant risk of resulting in a material adjustment to the carrying amount of assets and liabilities within the next financial year*' (IAS 1.125).

In 2011, IAASA corresponded with a number of issuers regarding:

- (a) the extent of their disclosures regarding items for which deferred tax had not been recognised in the Statement of Financial Position; and
- (b) the extent to which tax uncertainties required disclosure in the context of assumptions about the future and/or represented other major sources of estimation uncertainty.

In some instances IAASA found shortcomings in this regard and it is IAASA's view that, given the prevailing economic circumstances, Boards and Audit Committees should, where necessary to aid users' understanding, provide greater disclosures in this regard in their 2011 financial reports.

Due to the substantial uncertainty regarding the existence and/or recoverability of any potential tax asset, an issuer, depending on its particular circumstances, may not be in a position to make a reliable estimate of the quantum of any such tax asset(s). It is IAASA's expectation that, in situations where an issuer is not in a position to provide reliable quantitative disclosures regarding tax uncertainties, the issuer will provide a description of both its tax position and the associated assumptions and uncertainties.

²⁹ FRS 19 *Deferred tax* is the relevant accounting pronouncement for Irish GAAP issuers

9. Sovereign debt

In 2011, overall macro-economic risks have increased, reflecting a significant rise in sovereign risks in a number of European countries. Weaker growth prospects and higher downside risks have contributed to concerns about debt sustainability in the euro area. Market and liquidity risks have risen, partly as a result of increased macro-economic and sovereign risks. Higher volatility and rising yields on Government bonds issued by some European countries are threatening a loss of investor confidence and are contributing to increases in funding costs.

Downgrades in sovereign ratings have spread beyond Greece, Ireland and Portugal into larger Member States such as Italy and Spain. Elsewhere, political risks to achieving medium-term fiscal adjustment have risen in a few advanced economies, notably the US and Japan. Many sovereigns face multiple and interdependent risks, raising market concerns about debt sustainability.

Yields on Italian and Spanish sovereign bonds have risen significantly, reaching 7% for 10 year bonds. Refinancing conditions of European financial institutions continued to deteriorate in 2011 as evidenced by the increase in the 3 month interbank spread. Some tensions have also emerged on markets for secured funding (repo market) as repo rates on Italian and Spanish collateral have surged.

The continued pressures facing sovereign debt issuers and the effectiveness of international programmes to address such pressures impacts on the measurement of issuers' holdings – direct and indirect – of such debt.

Having regard to the foregoing, those issuers which have material holdings of sovereign debt should consider the following factors in preparing their 2011 financial statements:

IAS 39³⁰ requires that:

- (a) an issuer shall assess at the reporting date whether there is '*objective evidence*' that financial assets (e.g. holdings of sovereign debt) have been impaired; and
- (b) if such evidence exists, the issuer shall measure the impairment loss in accordance with IAS 39.63 which states that the loss is measured as the difference between the carrying amount of the asset and the present value of its expected future cash flows (IAS 39.58).

IAS 39.60 explicitly states that a downgrade of an entity's credit rating is not, of itself, evidence of impairment although it may be evidence of impairment when considered with other available information. IAS 39.59 provides examples of objective evidence that a financial asset is impaired.

In making assessments in this regard, issuers should carefully evaluate all the facts and circumstances at the reporting date. In addition, issuers should consider the need to provide disclosure to users of its financial statements regarding the considerations and assumptions made in assessing the existence of '*objective evidence*' and the associated impact on estimating future cash flows of sovereign debt.

Where, for loans and receivables and for financial assets classified as held to maturity (each of which is measured at amortised cost), there is objective evidence that those assets are impaired, the amount of the impairment loss is based on an assessment of expected future cash flows discounted at the asset's original effective interest rate. In instances where a restructuring plan is in place, such assessment should be based on the restructuring plan details. In instances where a restructuring plan is not yet agreed, issuers should ensure that the estimated cash flows are based on best estimates using all the available information.

For financial assets classified as available-for-sale or held-for-trading (each of which is measured at fair value), issuers need to determine whether the financial asset is regarded as quoted in an active

³⁰ For Irish GAAP issuers, FRS 26 (IAS 39) *Financial Instruments: Recognition and Measurement* is the relevant accounting pronouncement

market. While not yet EU endorsed, IFRS 9 *Financial Instruments* may provide useful guidance to issuers in this regard. Where a market for a financial asset is active, issuers should use the quoted price.

Issuers should carefully consider the extent of disclosures provided regarding holdings of sovereign debt including:

- (a) the amount of such holdings by country and maturity date;
- (b) the criteria applied in assessing whether or not there is '*objective evidence*' of impairment;
- (c) the assumptions made regarding estimated future cash flows; and
- (d) the uncertainties associated with the determination of the carrying amount of sovereign debt.

Readers may wish to refer to the ESMA³¹ Public Statement *Sovereign Debt in IFRS Financial Statements* issued on 25 November, 2011³².

10. Financial reporting considerations relevant to the making of distributions

Company law requires that, before a company can make a distribution (such as, for example, paying a dividend), certain criteria, including criteria relating directly to financial reporting, must be satisfied. IAASA's review activity has identified a number of instances in which certain legal and/or financial reporting related criteria had not been met in advance of the making of distributions by issuers.

The attention of Boards and Audit Committee is drawn to the relevant legislative provisions applying in this area, thereby assisting them in complying with their obligations in advance of the making of distributions.

In summary, sections 45 to 47 of the Companies (Amendment) Act, 1983³³ ('the 1983 Act') set out the legislative provisions for the determination of '*a company's profits available for distribution*' and the restrictions thereon.

Section 49(1) of the 1983 Act provides that the question of:

- (a) whether a distribution can be made without contravening sections 45 to 47 of the 1983 Act ; and
- (b) the amount of any distribution that may be so made,

shall be determined by reference to '*relevant accounts*'.

A company's '*relevant accounts*' are:

- (a) except in a case falling within (b) or (c) below, the last annual financial statements which were laid in respect of the last preceding financial year in respect of which financial statements so prepared were laid;
- (b) if a distribution would be found to be a contravention if reference was made only to the last annual financial statements, such interim financial statements as are necessary to enable a reasonable judgement to be made as to any of the relevant items³⁴;

³¹ European Securities and Markets Authority

³² Available at <http://www.esma.europa.eu/popup2.php?id=8073>

³³ The text of section 49 of the Companies (Amendment) Act, 1983 (as amended and substituted by Regulation 9 and the Schedule to the European Communities (International Financial Reporting and Miscellaneous Amendments) Regulations 2005 (S. I. 116 of 2005)) is set out in the Appendix to IAASA's Information Note at http://www.iaasa.ie/publications/Distributions_June2011.pdf

³⁴ The '*relevant items*', as defined in section 49(9), include profits, losses, assets and liabilities, provisions of any kind, share capital and reserves

- (c) if the distribution is proposed to be declared during the company's first financial year or before any financial statements are laid in respect of that financial year, such initial accounts as are necessary to enable a reasonable judgement to be made as to any of the relevant items³⁶.

In the case of interim accounts prepared for a proposed distribution by a public limited company, section 49(5) of the 1983 Act provides that the following additional requirements apply:

- (a) the interim financial statements must have been properly prepared (as defined by section 49(9)) or have been so prepared subject only to matters which are not material for the purpose of determining, by reference to the relevant items³⁶ as stated in those interim financial statements, whether the distribution would be a contravention; and
- (b) a copy of the interim financial statements must have been delivered to the Registrar of Companies.

Where a distribution made by a company to one of its members is made in contravention of the applicable provisions of the 1983 Act and, at the time of the distribution, the member knows or has reasonable grounds for believing that it is so made, the member shall be liable to repay it to the company or, in the case of a distribution made otherwise than in cash, to pay the company a sum equal to the value of the distribution at that time³⁵.

11. Materiality

Readers' attention is drawn to ESMA's Consultation Paper, *Considerations of materiality in financial reporting*³⁶, the publication of which was prompted, in part, by IAASA's publication entitled *Observations on Materiality in Financial Reporting*³⁷, which was issued in May 2010. The purpose of the Consultation Paper is to seek comments from interested parties on their understanding of various aspects of materiality in an effort to contribute to a consistent application of this important concept in financial reporting.

A recurring theme of discussions by those EU authorities charged with enforcing IFRS is the apparent differing views regarding the practical application of the concept of materiality amongst preparers, auditors, users of the financial reports and, in some instances, accounting enforcers themselves. The objective of general purpose financial statements is to provide information to a range of users for the purpose of economic decision making. To be useful, such financial statements must present fairly the financial position, performance and cash flows of the reporting entity. Where information which is required by the relevant financial reporting framework is omitted or misstated and such information could influence the economic decision making of a user, financial statements cannot be said to achieve a fair presentation. The concept of '*materiality*' is used to describe such information.

In that regard, readers are reminded that it is IAASA's clear expectation that where the disclosure of details regarding the quantitative and qualitative criteria applied in making materiality judgments is necessary in order to aid users' understanding of periodic financial reports, that issuers will disclose such information.

12. Presentational errors

In the course of its reviews, IAASA has identified a number of what might best be described as basic and straightforward errors in periodic financial reports.

In the instances identified, the issuers concerned have amended the comparative amounts in subsequent financial statements.

While the underlying cause of such presentational errors is not readily apparent, such errors could derive from the incomplete processing of 'late adjustments'.

³⁵ Section 50, Companies (Amendment) Act, 1983

³⁶ Available at http://www.esma.europa.eu/system/files/2011_373_.pdf

³⁷ Available at http://www.iaasa.ie/publications/Obs_materiality2010.pdf

It is IAASA's expectation that Boards and Audit Committees will ensure sufficient time and resources are directed to the finalisation of financial statements in order to minimise the risk of such wholly avoidable errors going undetected and uncorrected.

13. Exceptional items and non-recurring items

IFRS does not define the expression '*exceptional item*' or '*non-recurring item*'; however, IAS 1.97 states that:

'When items of income or expense are material, an entity shall disclose their nature and amount separately.'

IAS 1.85³⁸ is also relevant in this regard.

For Irish GAAP issuers, FRS 3.5³⁹ provides a definition of '*exceptional items*' and FRS 3.19–20 specifies the presentation and disclosure requirements.

IAASA has challenged issuers as to the presentation of such items in their financial reports, including issuers' rationale for separately disclosing or not disclosing such items.

It is IAASA's expectation that issuers would carefully consider whether such items warrant the disclosure of an accounting policy to aid users' understanding of the basis on which such items are identified and presented.

14. Interim reporting

It is IAASA's expectation that the requirements of IAS 34⁴⁰ will be adhered to in full by issuers in preparing half-yearly financial reports. In that regard, two particular requirements of IAS 34 are drawn to reader's attention:

- (a) IAS 34.15 states IAS 34.16A(g) requires the disclosure of specified segment information for entities applying IFRS 8; and
- (b) IAS 34.16A(i) requires disclosure of the effect of changes in the composition of the issuer during the interim period and, in the case of business combinations, the issuer shall provide the disclosures required by IFRS 3 *Business Combinations* (i.e. IFRS 3.59–63).

IAASA's review activity continues to identify instances in which issuers have failed to comply in full with these requirements.

15. New and amended accounting pronouncements

1.9 IAS 24 *Related Party Disclosures* (revised)⁴¹

Those charged with issuers' governance are reminded that the requirements of IAS 24 (revised) are effective for annual periods beginning on or after 1 January, 2011, with earlier application permitted.

IAS 24 requires issuers to disclose information about transactions with related parties. The principal changes in the revised Standard provide:

- (a) a partial exemption for Government-related entities: under the previous version of IAS 24, if a Government controlled, or significantly influenced, an issuer, the issuer was required to disclose information about all transactions with other entities controlled, or significantly influenced by the same Government. While IAS 24 (revised) still requires disclosures that are

³⁸ 'An entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented), when such presentation is relevant to an understanding of the entity's financial performance.'

³⁹ FRS 3 *Reporting financial performance*

⁴⁰ For Irish GAAP issuers, the relevant pronouncement is the ASB's *Statement: Half-Yearly Financial Reports*

⁴¹ FRS 8 *Related party disclosures* is the relevant accounting pronouncement for Irish GAAP issuers

important to users of financial statements it 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) a revised definition of a related party.

1.10 EU endorsement of pronouncements

The following table summarises the EU endorsement status of recent IASB⁴² pronouncements.

	Date issued	IASB effective date
Standards		
<i>Improvements to IFRSs (2010)</i> ⁴³	6 May, 2010	1 Jan., 2011
IFRS 9 <i>Financial Instruments</i>	12 Nov., 2009	1 Jan., 2015
IFRS 10 <i>Consolidated Financial Statements</i>	12 May, 2011	1 Jan., 2013
IFRS 11 <i>Joint Arrangements</i>	12 May, 2011	1 Jan., 2013
IFRS 12 <i>Disclosures of Interests in Other Entities</i>	12 May, 2011	1 Jan., 2013
IFRS 13 <i>Fair Value Measurement</i>	12 May, 2011	1 Jan., 2013
IAS 27 <i>Separate Financial Statements</i>	12 May, 2011	1 Jan., 2013
IAS 28 <i>Investments in Associates and Joint Ventures</i>	12 May, 2011	1 Jan., 2013
Amendments to extant Standards		
Amendments to IFRS 7 <i>Financial Instruments: Disclosures</i>	7 Oct., 2010	1 Jul., 2011
Deferred tax: Recovery of Underlying Assets (<i>Amendments to IAS 12</i>)		1 Jan., 2012
Severe Hyperinflation and Removal of Fixed Dates for First-Time Adopters (<i>Amendments to IFRS 1</i>)		1 Jul., 2011
Presentation of Items of Other Comprehensive Income (<i>Amendments to IAS 1</i>)		1 Jul., 2012
Amendments to IAS 19 <i>Employee Benefits</i>	16 Jun., 2011	1 Jan., 2013
Interpretations of extant Standards		
IFRIC ⁴⁴ Interpretation 20: <i>Stripping Costs in the Production Phase of a Surface Mine</i>		1 Jan., 2013

1.11 Improvements to IFRSs (2010)

In May 2010, the IASB issued *Improvements to IFRSs* as part of its programme of annual improvements to its Standards. The amendments addressed:

- (a) IAS 1 – clarification of Statement of Changes in Equity – for each component of equity an issuer shall present, either in the Statement of Changes in Equity or in the notes, an analysis of other comprehensive income by item;
- (b) IAS 27 – transitional requirements for amendments arising as a result of IAS 27;
- (c) IAS 34 – significant events and transactions – an issuer shall include in its interim financial report an explanation of events and transactions that are significant to an understanding of the changes in financial position and performance of the issuer since the end of the last annual reporting period;
- (d) IFRS 1 *First Time Adoption of International Financial Reporting Standards* – accounting policy changes in the year of adoption; revaluation basis as deemed cost; and use of deemed cost for operations subject to rate regulation;

⁴² International Accounting Standards Board

⁴³ *Improvements to IFRSs (2010)* has been endorsed by the EU. The remaining Standards, Amendments and Interpretations have not been EU endorsed at the date of publication of this document

⁴⁴ International Financial reporting Interpretations Committee

- (e) IFRS 3 – transition requirements for contingent consideration from a business combination that occurred before the effective date of IFRS 3 (revised); measurement of non-controlling interests; and un-replaced and voluntarily replaced share-based payment awards;
- (f) IFRS 7 – clarification of disclosures; and
- (g) IFRIC 13 *Customer Loyalty Programmes* – measuring the fair value of customer loyalty award credits.

1.12 IFRS 9 Financial Instruments

IFRS 9 represents the first part of a three-part project to replace IAS 39 with a new standard – IFRS 9. Work on proposals addressing the second part (i.e. the impairment methodology for financial assets) and the third part (i.e. hedge accounting) continue.

IFRS 9 (November, 2009) uses a single approach to determine whether a financial asset is measured at amortised cost or fair value, replacing the many different rules currently contained in IAS 39. The approach in IFRS 9 is based on how an issuer manages its financial instruments (its business model) and the contractual cash flow characteristics of the financial assets. The new Standard also requires a single impairment method to be used, replacing the different methods provided for in IAS 39.

In October, 2010, the IASB added sections to IFRS 9 addressing financial liabilities and the derecognition requirements of IAS 39 were also transferred to IFRS 9. These further changes complete the classification and measurement phase of the IASB's project to replace IAS 39. The new requirements address the problem of volatility in profit or loss arising from an issuer choosing to measure its own debt at fair value. This is often referred to as the '*own credit*' problem; with these new requirements, an issuer choosing to measure a liability at fair value will present the portion of the change in its fair value due to changes in the issuer's own credit risk in the other comprehensive income ('OCI') section of the Income Statement, rather than within profit or loss.

IFRS 9 applies to financial statements for annual periods beginning on or after 1 January 2015. Issuers are permitted to apply the new requirements in earlier periods; however, if they do, they must also apply the requirements in IFRS 9 that relate to financial assets.

Whilst IFRS 9 may be helpful to issuers in the context of the preparation of their 2011 financial reports, it is important to note that the Standard has not yet been endorsed by the EU.

1.13 IFRS 10 Consolidated Financial Statements, IFRS 11 Joint Arrangements, IFRS 12 Disclosures of Interests in Other Entities, IAS 27 Separate Financial Statements (revised), and IAS 28 Investment in Associates and Joint Ventures (revised)

On 12 May, 2011, the IASB issued a suite of Standards, namely IFRS 10, IFRS 11, IFRS 12, a revised version of IAS 27 (which has been amended to reflect the issuance of IFRS 10 but retains the current guidance for separate financial statements) and a revised version of IAS 28 (which has been amended for conforming changes based on the issuance of IFRS 10 and IFRS 11).

IFRS 10 was issued concurrently with IAS 27 (revised) and establishes a single control model that applies to all entities, including those that were previously considered special purpose entities under SIC⁴⁵-12 *Consolidation – Special Purpose Entities*. An investor controls an investee when it has both exposure to variable returns from the investee, and the ability to affect those returns through its power over the investee. The assessment of control is based on all facts and circumstances and the conclusion is reassessed if there is an indication that there are changes in facts and circumstances.

IFRS 11 supersedes IAS 31 *Interests in Joint Ventures* and SIC-13 *Jointly-controlled Entities – Nonmonetary Contributions by Venturers*. IFRS 11 classifies joint arrangements as either joint operations or joint ventures and focuses on the nature of the rights and obligations of the arrangement. IFRS 11 requires the use of the equity method of accounting for joint arrangements by eliminating the option to use the proportionate consolidation method.

⁴⁵ Standing Interpretations Committee

IFRS 12 establishes the provision of information on the nature, associated risks, and financial effects of interests in subsidiaries, joint arrangements, associates and unconsolidated structured entities, as disclosure objectives. IFRS 12 requires more comprehensive disclosure in comparison to IAS 27 or SIC-12, and specifies minimum disclosures that an entity must provide to meet the disclosure objectives.

Each of these Standards are effective for annual periods beginning on or after 1 January, 2013, with earlier adoption permitted provided each of the other Standards are also early adopted. However, entities are permitted to include any of the disclosure requirements in IFRS 12 into their consolidated financial statements without early adopting IFRS 12.

Whilst this suite of Standards may be helpful to issuers in the context of the preparation of their 2011 financial reports, it is important to note that the Standards have not yet been endorsed by the EU.

1.14 IFRS 13 Fair Value Measurement

In May 2011, the IASB issued IFRS 13 which establishes a single source of guidance for fair value measurement under IFRS. IFRS 13 provides a revised definition of fair value and guidance on how it should be applied where its use is already required or permitted by other standards within IFRS and introduces more comprehensive disclosure requirements on fair value measurement.

IFRS 13 is effective for annual periods beginning on or after 1 January, 2013, with earlier application permitted.

While approved by the IASB, the Standard has yet to be endorsed by the EU.

1.15 IAS 19 Employee Benefits (revised)

In June 2011, the IASB issued amendments to IAS 19. IAS 19 (revised) eliminates the option for deferred recognition of all changes in the present value of a defined benefit obligation and in the fair value of plan assets (including the 'corridor approach'). In addition, IAS 19 (revised) requires a net interest approach which replaces the expected return on plan assets and is designed to enhance the disclosure requirements for defined benefit plans. Boards and Audit Committees are recommended to consider the impact of these changes to accounting for pension benefits.

IAS 19 (revised) which is not yet EU endorsed, applies to annual periods beginning on or after 1 January, 2013, with earlier application permitted.

1.16 Amendments to IFRS 7

Disclosures – Transfers of Financial Assets (Amendments to IFRS 7) was issued in October, 2010. These amendments created new disclosure requirements in relation to derecognised financial assets. The amendments are required to be IASB applied for annual periods beginning on or after 1 July 2011 with earlier application permitted.

1.17 Amendments to IAS 12

Deferred Tax: Recovery of Underlying Assets (Amendments to IAS 12) was issued by the IASB in December, 2010. As well as amending IAS 12 the amendments supersede SIC-21 *Income Taxes – Recovery of Revalued Non-Depreciable Assets*. The amendments are required to be applied for annual periods beginning on or after 1 January, 2012. Earlier application is permitted.

1.18 Amendments to IFRS 1

Limited Exemption from Comparative IFRS 7 Disclosures for First-Time Adopters (Amendments to IFRS 1) was issued in January, 2010. The amendment is required to be applied for annual periods beginning on or after 1 July, 2010.

Severe Hyperinflation and Removal of Fixed Dates for First-Time Adopters (Amendments to IFRS 1) was issued in December, 2010. The amendments are required to be applied for annual periods beginning on or after 1 July, 2011 with earlier application permitted.

1.19 Amendments to IAS 1

Presentation of Items of Other Comprehensive Income (Amendments to IAS 1) was issued in June, 2011. The amendments, which are not EU endorsed, are required to be applied for annual periods

beginning on or after 1 July, 2012 with earlier application permitted. The amendment requires that an issuer presents separately:

- those items of OCI that would be reclassified to profit or loss in the future if certain conditions are met; and
- those that would never be reclassified to profit or loss.

Irish Auditing & Accounting Supervisory Authority
6 January, 2012

GLOSSARY OF TERMS

ASB	Accounting Standards Board
CGU	Cash Generating Unit
ESMA	European Securities and Markets Authority
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
KPIs	Key Performance Indicators
NCI	Non-controlling Interest (minority interest)
OCI	Other Comprehensive Income
Regulations, the	Transparency (Directive 2004/109/EC) Regulations 2007 (S.I. No. 277 of 2007) (as amended by the Transparency (Directive 2004/109/EC) (Amendment) Regulations 2010 (S.I. No. 102 of 2010)
SIC	Standing Interpretations Committee
SSAP	Statement of Standard Accounting Practice
VIU	Value in Use
1983 Act, the	Companies (Amendment) Act, 1983