

# JR news

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For 30 June 2009 and Future Reporting Periods

# 2009 Financial Reporting Update

**With the 2009 financial reporting season just around the corner, it is time to consider the issues that will be relevant this year. We note that unlike recent years, for many entities the key 2009 issues are likely to be driven by the current economic environment rather than changes in reporting requirements. Of course, changes continue to be made by the accounting standard setters and should be considered.**

Accordingly, this newsletter provides an overview of some current financial reporting issues and some of the key changes in reporting requirements effective for 30 June 2009 and future reporting periods.

### Current Reporting Issues

The following headline was on the front page of The Australian Financial Review on 2 June:

#### Regulator to crack down on auditors

- **Scrutiny of accounting strategies**
- **Directors warned of responsibilities**



Whilst auditors are mentioned, the headline also highlights that directors are being warned of their responsibilities. This is because, under the Corporations Act 2001 (the Act), an entity's directors are responsible for ensuring that the financial report is prepared in accordance with the Act, including ensuring compliance with accounting standards. Therefore, the issues noted below are not only relevant for auditors but also for financial report preparers and directors.

#### Going Concern

In the current economic environment, with reduced liquidity and increasing business failures, the appropriateness of the going concern assumption needs to be carefully considered.

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In particular, financial report preparers need to focus on the following requirements of AASB 101:

**“When preparing financial reports, management shall make an assessment of an entity’s ability to continue as a going concern. Financial reports shall be prepared on a going concern basis unless management either intends to liquidate the entity or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions that may cast significant doubt upon the entity’s ability to continue as a going concern, those uncertainties shall be disclosed.”**

In assessing an entity’s ability to continue as a going concern management considers the entity’s debt repayment schedules, compliance with borrowing covenants, ability to refinance debt, significant customer and supplier relationships, forecast cash flows and profitability amongst other factors. As noted above, where there are material uncertainties that may cast significant doubt upon the entity’s ability to continue as a going concern these uncertainties must be disclosed.

### Impairment AASB 136

With the changed economic environment many entities may be faced with lower profitability and cash flows. This, combined with lower asset values, may mean that in 2009 many entities will identify impairment indicators and, accordingly, have to perform an impairment test in accordance with AASB 136 for the first time since the initial adoption of IFRS. Of course, entities with goodwill or an intangible asset with an indefinite useful life, or not yet available for use, are required to perform impairment tests of such assets at least annually.

With regards to impairment testing, the Australian Securities and Investments Commission (ASIC) has recently commented that entities need to ensure:

- Cash generating units (CGUs) are appropriately identified. In particular, entities need to ensure that CGUs are identified at the appropriate level, which for goodwill is the lowest level within an entity at which goodwill is actually monitored for internal management purposes. This level cannot be larger than a segment as identified under AASB 114. If CGUs are not properly identified impairment losses may not be recognised as they may be shielded by other profitable operations.
- The requirements for determining recoverable amount are properly applied. In particular, for value in use calculations cash flow projections should be “realistic”. For example, AASB 136 says cash flow projections are to be based on reasonable and supportable assumptions. It also says that *“management shall ensure that the assumptions on which its current cash flow projections are based are consistent with past actual outcomes, provided the effects of subsequent events or circumstances that did not exist when those actual cash flows were generated make this appropriate.”*
- Impairment testing should include recently acquired assets, where appropriate. In particular, this may be relevant where assets were acquired prior to the change in the economic environment at higher values.
- The disclosure requirements of AASB 136 are complied with. For example, ASIC has noted instances where entities did not disclose:
  - discount rates and growth rates used in value in use calculations;

- explanations for using forecast periods of greater than five years; and
- sensitivity analysis in relation to changes in key assumptions.

### Impairment AASB 139

In the current environment many equity investments have suffered a decline in value. With regard to this, AASB 139 states that a *“significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment”* (the effect of any such impairment for an available-for-sale financial asset is to remove the loss from equity and recognise it in profit or loss). In a tentative agenda decision the International Financial Reporting Interpretations Committee (IFRIC) has recently noted that:

- The standard (AASB 139) cannot be read to require the decline in value to be both significant and prolonged.
- A significant or prolonged decline cannot be considered only an indicator of possible impairment in determining whether there is objective evidence. When such a decline exists, recognition of an impairment loss is required.
- The fact that the decline in the value of an investment is in line with the overall level of decline in the relevant market does not mean that an entity can conclude the investment is not impaired. Because each equity investment is unique, each must be considered separately for impairment. The existence of a significant or prolonged decline cannot be overcome by forecasts of an expected recovery of market values, regardless of their expected timing. Consequently, the IFRIC concluded that an anticipated market recovery is not relevant to the assessment of “prolonged”.

### Fair Value

The measurement of many assets is now based on fair value. For example:

- property, plant and equipment applying the revaluation model;
  - investment property applying the fair value model;
  - certain financial instruments accounted for under AASB 139, in particular equity investments and derivatives; and
  - biological assets
- are measured based on fair value.

Fair value must also be assessed for other items such as employee option grants (AASB 2) and identifiable assets, liabilities and contingent liabilities acquired in a business combination (AASB 3).

The determination of fair value for some of these items has become more difficult in the current environment with increased volatility, fewer comparable transactions and illiquid markets. Some transactions that are occurring may also reflect distressed or forced sales rather than sales between willing buyers and sellers.

This has been reflected in the financial press with some criticism of fair value or mark-to-market accounting. The standard setters have responded to this with a number of measures including:

- The release in October 2008 of the International Accounting Standards Board (IASB) Expert Advisory Panel report on Measuring and Disclosing the Fair Value of Financial Instruments in Markets that are No Longer Active.
- The release of amendments to AASB 7 and AASB 139 (refer below).
- The release in May 2009 by the IASB of an exposure draft on Fair Value Measurement.

The exposure draft proposes the adoption of a fair value hierarchy broadly consistent with that adopted in US GAAP. This hierarchy prioritises the inputs to valuation techniques used to measure fair value into three broad levels. These are:

- Level 1 – inputs are quoted prices (unadjusted) in active markets for identical assets or liabilities that the entity can access at the measurement date.
- Level 2 – inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly (i.e. as prices) or indirectly (i.e. derived from prices).
- Level 3 – inputs for the asset or liability that are not based on observable market data (unobservable inputs). Unobservable inputs are to reflect the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk.

The valuation techniques used to measure fair value should maximise the use of relevant observable inputs and minimise the use of unobservable inputs.

The above mentioned releases may provide useful guidance in considering fair value measurement issues this year.

ASIC has also commented that:

- where markets exist, entities should be careful in forming a view that a valuation technique provides a better estimate of fair value than a market transaction – even if the market is inactive;
- entities should ensure that their fair value estimates are up to date at reporting date – this is particularly relevant as volatility may have rendered previous fair value estimates inappropriate;
- models used to estimate fair value should be consistent from year to year, where appropriate, and be consistent with actual transactions undertaken; and
- entities should fully disclose the methods and significant assumptions used in estimating fair values, where appropriate.

### Other Issues

#### Key Judgements and Sources of Estimation Uncertainty

Entities are required to disclose:

- The judgements 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 report.
- Information about the key assumptions concerning the future, and other key sources of estimation uncertainty at the reporting date, that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities within the next annual reporting period.

In the current environment these disclosures may take on extra significance given increased volatility and uncertainty.

#### Current/Non-current Classification of Liabilities

A liability is classified as current when it satisfies any of the following criteria:

- (a) it is expected to be settled in the entity’s normal operating cycle;
- (b) it is held primarily for the purpose of being traded;
- (c) it is due to be settled within twelve months after the reporting date; or
- (d) the entity does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting date.

Accordingly, all liabilities must be assessed to determine whether they satisfy any of the above criteria. If they do, they must be disclosed as current. The Centro Property example shows how important this can be.

### Breaches of Loan Covenants

When an entity breaches an undertaking under a long-term loan agreement on or before the reporting date with the liability becoming payable on demand, the liability is classified as current, even if the lender has agreed, after the reporting date, not to demand payment as a consequence of the breach.

The liability is classified as non-current if the lender agreed by the reporting date to provide a period of grace ending at least twelve months after the reporting date within which the entity can rectify the breach and during which the lender cannot demand immediate repayment.

The current/non-current classification of liabilities, breaches of loan covenants and ability to refinance should also be considered in the going concern assessment.

### AASB 7 Disclosures

An objective of AASB 7 is to require disclosure of the nature and extent of risks arising from financial instruments to which an entity is exposed during the reporting period, and at the reporting date, and how the entity manages those risks.

In the current environment, with increased volatility and uncertainty, the risks to which an entity is exposed are likely to be more significant. As such, the disclosures required by AASB 7 themselves become more significant.

ASIC has commented that in 2008 some entities provided minimal or "boilerplate" disclosures that did not follow the principles and intent of the standard.

Accordingly, care needs to be taken in complying with the AASB 7 disclosures in 2009.

### Other

There are, of course, a range of other issues that entities will need to consider in preparing their financial reports this year. These include, for example, whether the continued recognition of deferred tax assets is appropriate as well as whether changed circumstances have given rise to any onerous contracts.

In summary, each entity needs to consider how it is effected by the changed economic environment. It then needs to develop and implement appropriate actions to ensure it complies with its financial reporting obligations.

## Key Changes in Financial Reporting Requirements

For many entities the changes in financial reporting requirements effective for 2009 are minimal. In fact, many entities may not be effected by current year changes at all. However:

- Some entities may need to reconsider compliance with requirements introduced in previous years. For example, some entities may need to improve their AASB 7 disclosures relating to financial instruments. ASX listed entities may also need to focus on improving compliance with their remuneration report disclosure requirements.
- The standard setters continue to introduce changes to financial reporting requirements. There are a number of changes already made which will be effective for 2010 and later years. Additionally, the IASB has a number of projects under way which will likely lead to further significant changes in the future.

Below we summarise some of the key changes in financial reporting pronouncements effective for 30 June 2009 and future reporting periods.

### 30 June 2009

Pronouncement	Commentary
AASB 2008-10 and AASB 2008-12 Reclassification of Financial Assets	Amends AASB 139 to permit an entity to: (a) reclassify non-derivative financial assets (other than those designated at fair value through profit or loss by the entity upon initial recognition) out of the fair value through profit or loss category in certain circumstances; and (b) transfer from the available-for-sale category to the loans and receivables category a financial asset that would have met the definition of loans and receivables (if the financial asset had not been designated as available-for-sale) in certain circumstances.  Amends AASB 7 to specify the disclosures required by an entity that reclassifies financial assets in accordance with the amendments to AASB 139.
AASB 2009-3 Embedded Derivatives	Amends AASB 139 and Interpretation 9 to clarify the requirements in relation to the treatment of embedded derivatives within a host contract that is reclassified out of the fair value through profit or loss category in accordance with the abovementioned amendments.
Interpretation 12 Service Concession Arrangements	This Interpretation gives guidance on the accounting by operators for public-to-private service concession arrangements.
Interpretation 13 Customer Loyalty Programmes	This Interpretation addresses customer loyalty programmes under which customers are granted customer loyalty award credits. It gives guidance on the accounting by an entity for customer loyalty award credits granted to its customers as part of a sales transaction and which, subject to meeting any further qualifying conditions, the customers can redeem in the future for free or discounted goods or services.
Interpretation 14 AASB 119 – The Limit on a Defined Benefit Asset, Minimum Funding Requirements and their Interaction	This Interpretation provides general guidance on how to assess the limit in AASB 119 Employee Benefits on the amount of the surplus that can be recognised as an asset by an employer sponsor. It also explains how the defined benefit surplus (asset) or deficiency (liability) recognised by an employer sponsor may be affected when there is a statutory or contractual minimum funding requirement.

In addition to the above, there are a number of public sector specific pronouncements which become effective for 2009.

### Future Reporting Periods

Pronouncement	Commentary
AASB 3 Business Combinations (applies prospectively to 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)	Replaces the existing AASB 3 and introduces significant changes. For example: <ul style="list-style-type: none"> <li>■ The acquirer must measure any non-controlling interest in the acquiree either at fair value (including goodwill) or as the non-controlling interest's proportionate share of the acquiree's net identifiable assets.</li> <li>■ Costs the acquirer incurs in connection with the business combination are recognised as expenses (rather than included in goodwill).</li> <li>■ Consideration transferred by the acquirer, including contingent consideration, must be measured and recognised at fair value at the acquisition date. Subsequent changes in the fair value of contingent consideration may be recognised in profit or loss or in accordance with other relevant standards.</li> <li>■ Application guidance was added in relation to when the acquirer is obliged to replace the acquiree's share-based payment awards; measuring indemnification assets; rights sold previously that are reacquired in a business combination; operating leases; and valuation allowances related to financial assets such as receivables and loans.</li> <li>■ For business combinations achieved in stages an acquirer must remeasure any equity interest it holds in the acquiree immediately before achieving control at its acquisition-date fair value and recognise the resulting gain or loss, if any, in profit or loss.</li> </ul>
AASB 8 Operating Segments*	Replaces the existing AASB 114 and introduces significant changes. For example: <ul style="list-style-type: none"> <li>■ AASB 8 applies to a for-profit entity whose debt or equity instruments are traded in a public market or that files, or is in the process of filing, its financial statements with a securities commission or other regulatory organisation for the purpose of issuing any class of instruments in a public market. AASB 114 applied to a broader range of for-profit entities.</li> <li>■ The requirements of AASB 8 are based on the information about the components of the entity that management uses to make decisions about operating matters. AASB 8 requires identification of operating segments on the basis of internal reports that are regularly reviewed by the entity's chief operating decision maker in order to allocate resources to the segment and assess its performance.</li> <li>■ AASB 8 requires the amount reported for each operating segment item to be the measure reported to the chief operating decision maker for the purposes of allocating resources to the segment and assessing its performance.</li> <li>■ AASB 114 defined segment revenue, segment expense, segment result, segment assets and segment liabilities. AASB 8 does not define these terms.</li> </ul>
AASB 101 Presentation of Financial Statements*	Replaces the existing AASB 101 and introduces significant changes. For example: <ul style="list-style-type: none"> <li>■ The new standard requires:  <ul style="list-style-type: none"> <li>(a) owner changes in equity to be presented separately from non-owner changes in equity. An entity is not permitted to present components of comprehensive income (i.e. non-owner changes in equity) in the statement of changes in equity;</li> <li>(b) income and expenses to be presented in one statement (a statement of comprehensive income) or in two statements (a separate income statement and a statement of comprehensive income);</li> <li>(c) components of other comprehensive income to be displayed in the statement of comprehensive income; and</li> <li>(d) total comprehensive income to be presented in the financial statements.</li> </ul> </li> <li>■ A balance sheet is to be presented as at the beginning of the earliest comparative period when an entity applies an accounting policy retrospectively, or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements.</li> </ul>

Pronouncement	Commentary
AASB 123 Borrowing Costs*	In relation to borrowing costs directly attributable to the acquisition, construction or production of a qualifying asset, the revised AASB 123 only permits entities to capitalise the borrowing costs as part of the carrying amount of the qualifying asset.
AASB 127 Consolidated and Separate Financial Statements (applicable for annual reporting periods beginning on or after 1 July 2009)	Replaces the existing AASB 127 and introduces significant changes. For example: <ul style="list-style-type: none"> <li>■ The term minority interest is replaced by the term non-controlling interest.</li> <li>■ An entity must attribute total comprehensive income to the owners of the parent and to the non-controlling interests even if this results in the non-controlling interests having a deficit balance.</li> <li>■ Changes in a parent's ownership interest in a subsidiary that do not result in the loss of control must be accounted for as equity transactions.</li> <li>■ Any investment retained in a former subsidiary on the loss of control is measured at its fair value at the date when control is lost.</li> </ul>
AASB 2008-1 Share-based Payments: Vesting Conditions and Cancellations*	Amends AASB 2 to clarify that vesting conditions comprise service conditions and performance conditions only and that other features of a share-based payment transaction are not vesting conditions. Also specifies that all cancellations, whether by the entity or by other parties, should receive the same accounting treatment.
AASB 2008-2 Puttable Financial Instruments and Obligations arising on Liquidation*	Amends AASB 132 to introduce an exception to the definition of financial liability to classify as equity instruments certain puttable financial instruments and certain instruments that impose on an entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation of the entity.
AASB 2008-5 Amendments to Australian Accounting Standards arising from the Annual Improvements Project*	Amends numerous standards as a result of the IASB's first annual improvements project. The amendments may impact presentation, recognition and measurement. A summary of the principle changes is set out in the Main Features section of the standard.
AASB 2008-6 Further Amendments to Australian Accounting Standards arising from the Annual Improvements Project (applicable to annual reporting periods beginning on or after 1 July 2009)	Amends AASB 1 and AASB 5 to include requirements relating to a sale plan involving the loss of control of a subsidiary.
AASB 2008-7 Cost of an Investment in a Subsidiary, Jointly Controlled Entity or Associate*	Amends various standards including: <ul style="list-style-type: none"> <li>■ Removing from AASB 118 the requirement to deduct dividends declared out of pre-acquisition profits from the cost of an investment in a subsidiary, jointly controlled entity or associate. Therefore, all such dividends are recognised by the investor as income.</li> <li>■ AASB 136 to include recognising a dividend from a subsidiary, jointly controlled entity or associate, together with other evidence, as an indication that the investment in the subsidiary, jointly controlled entity or associate may be impaired.</li> </ul>
AASB 2008-8 Eligible Hedged Items (applicable to annual reporting periods beginning on or after 1 July 2009)	Amends AASB 139 to clarify how the principles that determine whether a hedged risk or portion of cash flows is eligible for designation as a hedged item, should be applied in particular situations.
AASB 2009-2 Improving Disclosures about Financial Instruments*	Amends AASB 7 to require enhanced disclosures about fair value measurements and liquidity risk. For example, the amendments: <ul style="list-style-type: none"> <li>■ Require disclosure of any change in a method for determining fair value and the reasons for the change.</li> <li>■ Introduce a three-level hierarchy for making fair value measurements (similar to that referred to above in the commentary on the May 2009 Fair Value Measurement exposure draft).</li> <li>■ Require disclosure about the relative reliability of each fair value measurement in the statement of financial position.</li> <li>■ Clarify that the current maturity analysis for non-derivative financial instruments should include issued financial guarantee contracts.</li> <li>■ Require disclosure of a maturity analysis for derivative financial liabilities.</li> </ul>
Interpretation 15 Agreements for the Construction of Real Estate*	This Interpretation applies to the accounting for revenue and associated expenses by entities that enter into agreements for the construction of real estate directly or through subcontractors. It addresses two issues: <ol style="list-style-type: none"> <li>(a) Is the agreement within the scope of AASB 111 Construction Contracts or AASB 118 Revenue?</li> <li>(b) When should revenue from the construction of real estate be recognised?</li> </ol>
Interpretation 16 Hedges of a Net Investment in a Foreign Operation (applicable to annual reporting periods beginning on or after 1 October 2008)	This Interpretation provides guidance on accounting for the hedge of a net investment in a foreign operation in an entity's consolidated financial statements. It applies to an entity that hedges the foreign currency risk arising from its net investments in foreign operations and wishes to qualify for hedge accounting in accordance with AASB 139.
Interpretation 17 Distributions of Non-cash Assets to Owners (applicable prospectively to annual reporting periods beginning on or after 1 July 2009)	This Interpretation provides guidance on how an entity should measure distributions of assets other than cash when it pays dividends to its owners, except for common control transactions. It clarifies that: <ol style="list-style-type: none"> <li>(a) a dividend payable should be recognised when the dividend is appropriately authorised and is no longer at the discretion of the entity;</li> <li>(b) an entity should measure the dividend payable at the fair value of the net assets to be distributed; and</li> <li>(c) an entity should recognise the difference between the dividend paid and the carrying amount of the net assets distributed in profit or loss.</li> </ol>
Interpretation 18 Transfers of Assets from Customers (applies prospectively to transfers of assets from customers received on or after 1 July 2009)	This Interpretation applies to agreements in which an entity receives from a customer an item of property, plant and equipment (or cash to construct or acquire it) that the entity must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services, or to do both.

\* applicable to annual reporting periods beginning on or after 1 January 2009.

With regard to the changes applicable in future reporting periods it should be noted that:

- The above list and commentary are not exhaustive. For example, the IASB has a number of projects under way which could lead to significant changes in various standards such as accounting for income tax, revenue and leases to name a few.
- The changes should be considered in complying with the AASB 108 requirement to disclose information when an entity has not applied a new Australian Accounting Standard that has been issued but is not yet effective.
- The changes, in most cases, can be adopted early (check the particular pronouncement to ensure this can be done and any transitional requirements).
- For some entities, the changes may help in determining an accounting policy or applicable disclosure for items not previously addressed.



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