

TRANSITIONAL AND IMPLEMENTATION ISSUES ON INTERNATIONAL FINANCIAL REPORTING STANDARDS¹

TRANSITIONAL ISSUES

Issue: Whether to allow a transition period for corporations considering the impact of the adoption of IFRS.

The grant of gradual transition to IFRS by the SEC was limited to the following:

Non-publicly Accountable Entities (NPAEs)

The Commission adopted in 2005 Philippine Accounting Standard (PAS) 101 which allowed Non-Publicly Accountable Entities (NPAEs) to defer compliance with the full IFRS. The Commission recently adopted the amendment to PAS 101, deleting the effective date of 2005 to 2007 and instead stating that it will be in effect until withdrawn.

Under PAS 101, NPAEs are allowed to continue filing financial statements in accordance with Philippine GAAP as of 2004. NPAEs are those entities which do not hold a secondary license from the Commission or do not conduct fiduciary capacity on behalf of the public such as banks, financing companies, or entities which are not economically significant particularly those with less than P250 Million total assets or P150 Million in total liabilities. Such amounts shall be determined on the basis of the total assets or liabilities as of the beginning of the reporting period. For example, an ordinary company shall qualify as an NPAE for its 2006 AFS if its total assets or liability as of January 1, 2006 is below the aforementioned amounts.

The International Accounting Standards Board (IASB) is also aware of the need for a separate set of accounting standards for said kind of entities. IASB has already an exposure draft on accounting standards for small and medium enterprises (SMEs) which has been published for public comments.

Mutual funds. Mutual funds or investment companies were given until September 2006 to shift from accrual method to mark-to-market valuation of their financial instruments. Prior to that shift, the companies were required to disclose on a quarterly basis the possible quantitative impact of the new valuation method on the Net Asset Value to fully apprise the investors.

¹ In the Philippines, these are adopted as Philippine Financial Reporting Standards (PFRS) and Philippine Accounting Standards (PAS)

Mining Companies. Mining companies with long-term hedging contracts which were entered into and became effective prior to January 1, 2005 were granted transitional relief from PAS 39 (*Financial Instruments: Recognition and Measurement*). Under this transitional relief, certain commodity derivative contracts of mining companies were “grandfathered” and exempted from the fair value requirements of PAS 39. Based on the records of the Commission, only one (1) mining company was granted to this transition relief.

Pre-need Companies. Due to the hybrid nature of pre-need plans, the industry raised an issue on the applicability of PAS 39 with respect to the recognition and measurement of pre-need liability and revenue. The Commission deferred the implementation of PAS 39 on said instruments as of end of December 31, 2005.

As a result of the study and deliberation on the matter, the Commission resolved in April 2007 to adopt PAS 37 (*Provisions, Contingent Liabilities and Contingent Assets*) for the accounting treatment of the liability of pre-need companies and PAS 18 (*Revenue*) for revenue recognition. These are embodied in the ***Amended Pre-Need Rule 31 (Accounting Standards for Pre-Need Plans and Pre-Need Uniform Chart of Accounts)*** along with the other changes made on the accounting principles and presentation requirements for the pre-need corporations.

Exemptive Relief Granted

The Commission granted the exemption requested by the Bureau of Treasury pertaining to the exchange transactions covered by the Domestic Exchange Offer of government securities by the Bureau of Treasury, particularly from the “tainting provisions” of PAS 39. It was granted due to the fact that the re-classification is non-recurring and could not have been anticipated by the entity, and considering that the success of the exchange is in the interest of the country. Said exemption was however granted on the condition that the entities that opt to exchange their eligible bonds shall not immediately recognize any gains or losses in the Income Statement for the period. Any such unrealized gains or losses shall be amortized over the term of the bonds obtained from the exchange.

IMPLEMENTATION ISSUES

Fair Value Issue

The adoption of IFRS led to a large extent towards an accounting model that focuses on asset/liability recognition and measurement which uses fair valuation approach. Issues were encountered in applying the fair value accounting some assets and liabilities and equity instruments including pension assets and liabilities, derivative financial instruments, certain other financial assets, financial liabilities held for trading, tangible and intangible fixed assets acquired in a business combination, impaired or revalued assets held for disposal, share-based payment liabilities, and biological assets. However, guidance on measuring fair value is dispersed throughout IFRSs and is not always consistent.

The fair value definition used in IFRS is essentially “market value” or “the amount for which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.” There is continuing concern on whether fair value can be practically applied to assets and liabilities for which there is no contractual or active market available and what this means for the reliability and objectivity of a set of IFRS accounts in the future.

In the Commission’s review of the 2005 audited financial statements of certain corporations, it noted the misapplication of the fair value concept by few entities. One company used “zonal valuation” in fair valuing its Property and Equipment which is not consistent with the definition in IFRS. For non-listed securities, one company failed to justify its fair valuation based on a different technique.

To help address the issue of fair valuing non-listed securities, the Commission issued a guidance which allows the use of other valuation techniques as long as the following conditions are met:

- (1) the fair valuation study is conducted by an independent financial institution which is an expert on valuing securities;
- (2) the study is supported by reliable, verifiable and adequate data;
- (3) the valuation techniques used has the following features: (a) it makes maximum use of market inputs; (b) it reasonably reflects how the market could be expected to price the instrument; (c) the inputs to the valuation technique reasonably represent the market expectations and measures the risk-return factors inherent in the financial instrument.

Looking forward, the International Accounting Standards Board (IASB) has already published a Discussion Paper on fair value measurements. The proposal would not however introduce new measurements at fair value but would establish a concise definition of fair value and single source of guidance for all fair value measurements required by IFRSs.

Functional Currency

Functional Currency is a concept that was introduced into IAS 21, *The Effects of Changes in Foreign Exchange Rates* when it was revised in 2003.

The previous version of IAS 21 used a concept of “reporting currency”. Examples were given on how an entity determines a currency for measuring items in its financial statements, defined as “measurement currency”.

In revising IAS 21 in 2004, the IASB’s main objective was to provide additional guidance on the translation method and on determining the functional and presentation currencies. Note that the notion of a group functional currency does not exist under IFRS; functional currency is purely an individual entity or business-operation based concept.

This has resulted in IAS 21 becoming one of the more complex standards both for companies converting to IFRS and for current users adopting the revised standards. Moreover, many multinational groups have found the process time consuming and challenging, particularly when considering non-trading group entities where the standard's emphasis on external factors suggests that the functional currency of corporate subsidiaries might well be that of the parent, regardless of their country of incorporation or the currency in which their transactions are denominated.

Going forward, all entities applying IFRS need to remember that the assessment of functional currency is a key step when considering any change in the group structure or when implementing any new hedging or tax strategies. Furthermore, should the activities of the entity within the group subsequently change for any reason, the determination of the functional currency of that entity should be reconsidered to identify the changes required.

One of the key steps to consider when undertaking the changeover to IFRS in the future is the determination of functional currency. Management must take care to document the approach followed in the determination of functional currency for each entity within the group, using a consistent methodology across all cases, particularly when factors are mixed and an exercise of judgment is required.

Disclosure Issue

Disclosures of sufficient information are themselves critical aspects of IFRS. The standards require a lot of information to be provided in the notes to financial statements. In the past, the Commission merely receives three to five page-financial statements. Under the IFRS, a minimum of ten-page financial statement is needed to adequately comply with the disclosure requirements of the IFRS.

In its review of the 2005 AFS, the Commission raised several comments pertaining to information that were not disclosed by companies on the basis of PAS 1 which allows non-disclosure if information are not material. Based on said PAS 1 however, there is no threshold of materiality. The Commission is of the position however that an information is material if the decision of the readers of the financial report would be affected upon the knowledge of such information. For quantitative information, the Commission uses an internal threshold of 5% of the aggregate amount of relevant accounts, to determine materiality thereof. If there is any doubt however on whether to disclose or not an information, the company should be prudent enough to disclose such information.

Another disclosure issue is the confidentiality of information as claimed by certain companies particularly on the compensation benefits of key management personnel. However, since the IFRS does not provide exemption due to confidentiality, the corporations can not use such excuse for non-disclosure of said required information. In its review of the 2005 AFS, the Commission noted the increasing compliance with the disclosure requirements on related party transactions and compensation benefits of key management personnel.

Other Issues

During the review of the 2005 AFS, the Commission likewise noted other few issues that some companies need to address such as the proper impairment of assets, disclosure of going concern issue due to continuing losses or capital deficiency and recognition of redeemable preferred shares as liability. In the deliberation with the concerned companies, the need to comply with the specific requirements of the standards relative to the said issues was clarified. The guidance appended to each standard are valuable inputs that can help the companies properly adopt and comply with the international principles and practices.

Please see list of findings on the 2005 Audited Financial Statements posted in this section.