**Financial Update PT1**

Hi, my name’s Steve Carlyle and this is the first of two International Financial Reporting Standards updates prepared in September 2011.

The standards we are going to look at in this podcast are as follows. There are three standards on groups; the first one is IFRS10 on control and consolidation. The second one is IFRS11 on joint arrangements and the third one, which I’ll say least about I think, is IFRS12 on group disclosures. The last standard we are going to have a look at is the IFRS13 which is on fair value, very important standard this last one, because it deals with fair value whenever it crops up in any other accounting standard, so it is a little bit of a hub standard as I might describe it.

Group accounting; first of all I am going to deal with the group accounting standards. Now there have been a number of standards dealing with group accounting that have come out over the last couple of years. There has been International Accounting Standard number 27 that has been updated and International Financial Reporting Standard number 3 which has also been updated. So there are two new standards that have been issued over the last couple of years. I am not going to be dealing with them in detail today but they deal with treatment or minority interest, they deal with accounting for goodwill.

These new standards that I am going to deal with now have all come out together, three standards, IFRS10, IFRS11 and IFRS12, so we are going to start with IFRS10.

IFRS10 is on control and consolidation. This standard focuses on the definition of a subsidiary, when do we have a subsidiary, and the focus of the standard is on control. So over a couple of decades the definition of subsidiary has moved from being a very simple one based around the ownership of shares to been a more subjective definition but based upon the idea that subsidiary is a business that you control. And of course you could control a company without owning any shares in it whatsoever, so we need to remember that, control is what the new definition is based around.

So the key features of IFRS10 are that the standard uses what is called the Single Economic Entity Model. Now this is an idea that was actually introduced in International Accounting Standard 27 when it was revised and followed on with International Financial Reporting Standard number 3 when it was revised. The single Economic Entity Model is the model that treats the group and all of its shareholders as if it is one single entity. So the minority shareholders, for example, are treated as if they are part of the wider group shareholding rather than been treated as outsiders to the group. And that has implications. For example, when we transact with the minority, if for example, the holding company increases its shareholding by buying shares off the minority then using the Single Economic Entity Model that will not create any goodwill and likewise if the holding company sells its shares to the minority shareholders to create a larger minority shareholding that will not create any profit or loss on sale in the group accounts. So, IFRS10 simply repeats the idea that we are using the Single Economic Entity Model for dealing with our subsidiaries.

A key part of the standard though, is the part that defines what a subsidiary is and I’ll just read that to you, the standard says that ‘an entity controls an investee when it has the power to direct the activities of the investee’. So, you have a subsidiary when you control it and what control means is where you have the power to direct the activities of that subsidiary, that’s what that definition is telling you.

This new definition of control will have very little impact for normal operating companies, most companies who have 100% owned subsidiaries where they own all of the shares will simply carry on as normal, those subsidiaries will continue to be subsidiaries after this new definition of control has been introduced. Where is does make a difference though is for organisations who have, perhaps, minority shareholdings in other businesses but they are still able to direct those other businesses because, for example, they may have significant loans that are outstanding from those investees. They may, for example, also have significant levels of business that they transact with the investees, so holding a shareholding of say 45% but being able to control that company because of the level of business you do with them would make that other business a subsidiary via this definition.

The key impacts of this change of definition however are thought to be in the financial services sector where the thinking, currently, is that this will mean that a number of businesses that financial service organisations invest in may fall to be treated as subsidiaries under this new definition.

So that’s IFRS10, it introduces a new definition of control and says that where you control another business then that business is a subsidiary

Now we are going to come and have a look at IFRS11 which is on joint arrangements and deals with the area of joint ventures, that is the key one that we perhaps are interested in. So IFRS11.

The key features of IFRS11 are that it says that we have a joint venture when there is joint control of an organisation. So joint control might mean that there is a business setup, a clearly defined business, which owns its own assets and its own liabilities and has its own income and own expenditure. This business may very well be incorporated as a limited company. And that business is owned jointly by two or more venturers. So it could be held 50/50 between two other businesses, it could be held 30%, 30%, 40% split between three business, the key though is that the control of that business is shared amongst the venturers. If we have that situation then this IFRS says that we should use equity accounting only for the joint venture. Now that is a change to the rules in the past because under the previous standard on joint arrangements the International Accounting Standard allowed for a choice of two treatments, you could either use equity accounting or you could use proportional consolidation. Remember, equity accounting is the same treatment that we would use for associates and now that’s the only treatment allowed for joint ventures.

The standard also deals with joint operations. An example of a joint operation might be that, for example, in the oil and gas industry where an oil platform is been operated by a number of different parties. There could be a party that owns the platform itself, there could be another party that owns the drilling equipment, there could be a party that provides the technical expertise and engineering support and all of these parties have invested in the oil rig so that they can extract oil and make a profit. However, there isn’t in this situation an entity as such, there isn’t a separate business that those parties are controlling between them, it’s just that they have decided to share expertise and assets in order to produce a profit and in this situation we would not treat this as a joint venture because there isn’t an entity there that is jointly controlled. What we would do in this situation in accounting terms is we would simply get each of the parties involved in the joint operation to account for their own assets and liabilities and their own income and expenditure. If any of them share assets or liabilities then they would account simply for their portion of that in their own financial statements.

Finally we move onto the last of the standards on groups that came out in May this year which is International Financial Reporting Standard number 12 on disclosures of subsidiaries, associates, joint ventures and other investments. This standard simply deals with the difference disclosures that are required for those four different types of investment. So for subsidiaries, for example, there will be considerably more disclosures required than there will be for simple investments. And it’s basically a hierarchy of disclosures, so the most disclosures are for subsidiaries and that is reduced for associates, reduced for joint ventures and then reduced for other investments that fall outside the first three. But if you are ever preparing a set of International Financial Reporting Standards then you would look to that particular standard for the disclosures.

Just one other thing here, International Accounting Standard number 27 and number 28 have had to be updated, they both involve associates and group accounting and they have been updates to fall into line with these new standards.

Finally on this International Financial Reporting Standard update, we are going to deal with the standard on fair value. And this is a really important standard because there are a number of different standards that use the term fair value and never before have we had one single definition of what fair value means. So, for example, in the standard on property, plant and equipment where we are re-valuing perhaps a piece of property we need to use the fair value of that property for our revaluation. So the term fair value is used in that standard and is defined in a certain way within that particular standard. Then we perhaps have the financial instruments standard which again uses the term fair value because financial instruments in certain circumstances have to be re-valued to fair value and that uses a slightly different definition of the term fair value.

So what has happened here with the introduction of this standard IFRS13 is that they have created one single definition of the term fair value. And the idea is that in the future any standard that uses the term fair value will be automatically cross-referenced to this standard so that you will use this definition and this standard of what fair value means.

So what does the standard actually say? Well, first of all as I have just said, just to repeat it, this is a universal concept across all standards. This standard doesn’t say when we have to use fair value it just says how we use fair value. So in other words this standard does not require any company in any circumstance to re-value their assets to fair value, that is not the purpose of the standard. The only purpose of this standard is that if you are going to use fair value to introduce or re-value any of your assets then this standard tells you how to work out that fair value. And this is the definition of what they mean by fair value, it goes like this, ‘fair value is the price that will be received to sell an asset or the price that will be paid to transfer a liability in an orderly transaction between market participants at the measurement date’. So the standard uses an exit price notion. It uses the idea that the fair value is something, is the value, at which we can get rid of it at. Either getting rid of an asset or getting rid of a liability. Historically fair value has had a number of different meanings but this is a very simple straightforward definition contained in this standard.

And that’s it really, that’s all I’ve got to say for this financial reporting update, there is another International Financial Reporting Update that I have prepared and recorded for September 2011 which deals with standards that are changing, that haven’t yet come into being, so you might like to listen to that one as well.

My name is Steve Carlyle from Clearly Training, thanks very much for listening and goodbye.