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IFRS accounting standards to watch out for in an uncertain economy

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During times of economic uncertainty, one might expect that an entity would have fewer accounting issues to consider because activity levels often decrease. However, the opposite is quite often the case. While not new, there are a number of IFRS accounting standards that often take on increased importance when times get tough.

Option re-pricing/modifications (IFRS 2)

Options are often re-priced to a lower strike price or have their maturity dates extended if share prices are low. These types of modifications generally increase the value of an option from its value immediately prior to the modification. Any increased value must be brought into income over the remaining vesting term of the option, in addition to the original fair value of the option, resulting in increased stock based compensation expense. A modification that results in a decreased option value is ignored.

Debt restructuring/modifications (IAS 39)

Borrowing arrangements are often modified through negotiations with lenders if the borrower is having difficulty meeting payment terms. If the modified terms of a lending arrangement result in a "substantial modification" of its terms, the original debt must be removed from the balance sheet with a gain or loss recognized and a new liability set up at fair value. A "substantial modification" of a financial liability occurs when the discounted present value of cash flows under the new terms (net of any fees paid) is at least 10% different than the remaining discounted present value of the remaining cash flows under old debt terms – both discounted at the original effective rate of the old debt.

Settlement of debts with shares (IAS 39 and IFRIC 19)

Entities will often settle outstanding debts by issuing equity when cash is tight. When equity is issued to extinguish a liability, you must measure equity at fair value unless it can't be reliably measured. This will result in a gain or loss upon de-recognition of the liability. In rare cases where fair value cannot be reliably measured, the equity instruments can be measured to reflect the fair value of the financial liability extinguished.

Paying employees with shares, rather than cash (IFRS 2)

This situation is really no different than giving employees options, but the shares likely just "vest" quicker. Due to the difficulty of directly measuring the fair value of the employee services received, entities normally measure the fair value of these services by reference to the fair value of the equity instruments granted, resulting in a charge to income as compensation expense.

Violation of bank covenants (IFRS 7 and IAS 1)

An entity must consider whether covenant violations result in the lender being able to demand – or accelerate the maturity date of – a loan, necessitating its classification as a current liability at the end of the reporting period. An entity must also disclose:

i) details of any defaults during the period,

ii) the carrying amount of the loans payable in default at the end of the reporting period; and

iii) whether the default was remedied, or the loans renegotiated, before the financial statements were authorized for issue.

Remember that IFRS considers the conditions existing at the balance sheet date for classification of items as current versus long-term. If a loan is subject to demand or matures within 12 months due to covenant violations at the balance sheet date, it must be shown as current, even if the covenant violation is remedied or waived by the lender subsequent to the balance sheet date.

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Impairments (IAS 36, IFRS 6)

When the economy is struggling, there is obviously going to be a greater chance that assets are impaired and need to be written down. The key thing to remember is that impairment tests are a two-part test. First, you assess whether there are indications of impairment of an asset or cash-generating unit ("CGU"). This can include external economy-wide factors and internal factors specific to the entity's own unique circumstances.

Only if there are indicators of impairment do you proceed to the second step, where you compare the carrying amount of the asset or CGU to the recoverable amount to measure the amount of impairment, if any. The recoverable amount of an asset or CGU is the higher of its fair value less costs of disposal and its value in use.

Going concern (IAS 1, CAS 570)

An entity must prepare its financial statements on a going concern basis unless management i) intends to liquidate the entity ii) intends to cease trading or iii) has no realistic alternative but to do i) or ii). Remember that the going concern assessment and disclosure is management's opinion, not the auditor's. The auditor is required to put an "emphasis of matter" paragraph in their audit report to draw the readers' attention to the going concern disclosure.

Assets held for sale (IFRS 5)

Entities will often attempt to liquidate some of their assets when cash gets tight. This may require the reclassification of assets on the balance sheet. An asset is required to be reclassified as held for sale if it is i) available for immediate sale in its present condition and ii) the sale is highly probable. IFRS 5 lists five criteria you need to meet for a sale to be highly probable.

If you meet the criteria above, you are required to i) measure the asset(s) at the lower of their carrying amount and fair value less costs of disposal, ii) discontinue amortizing the asset(s) while they are categorized as held for sale and iii) present the asset(s) as current on the balance sheet. Also, the above criteria must be met at the balance sheet date to allow for reclassification on the balance sheet.

So, when times get tough, the accounting issues you need to address might get tough as well.

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