

Asset revaluation: additional IFRS planning considerations

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As 2011 quickly approaches, so does the implementation date for International Financial Reporting Standards (IFRS) for publicly accountable organizations in Canada. Although there's been much written about the changes required to financial reporting, and many organizations are beginning to consider the impact on their business, there may be some additional IFRS consequences to consider as part of an adoption plan.

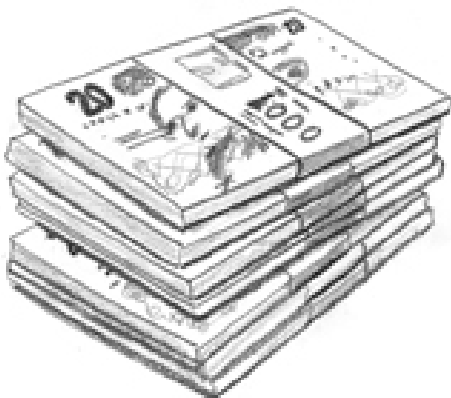
Fair value measurement option

One of the key changes for Canadian entities adopting IFRS is the ability to choose an accounting policy to measure property, plant and equipment (IAS 16) as well as other assets, such as intangible assets (IAS 38) and investment properties (IAS 40), at **fair value**. (IAS 40 defines investment properties as properties held to earn rent or for capital appreciation or both.)

Furthermore, on initial adoption of IFRS, there's a one-time option to revalue property, plant and equipment and other assets to fair value (even if the accounting policy subsequently chosen is **not** to value property, plant and equipment and other assets at fair value).

In addition to the increased disclosure related to such revaluation, a few other consequences may need to be considered. The following industries provide examples:

- Real estate—What if an executive's remuneration or management fees are based on company performance as reported under GAAP? With IFRS, valuation gains and losses now come into play and may affect the earnings determinations. How do these changes affect the remuneration or management fees calculations?



- Financial institutions—What about a loan covenant that requires a certain debt-to-equity ratio which would be affected by asset revaluation under IFRS? The borrower may benefit from a higher value for their assets, but has the lender's position been compromised?
- Manufacturing—How do you measure company performance? Who is the one choosing which class of assets to revalue, deciding on assumptions to value the assets internally, or selecting the external vendor to provide a valuation? If a drop in the value of property in a year occurs, and the loss all but wipes out a company's operating profit, does this reflect poor management of company resources? How often will the assets be revalued? Are competitors revaluing and experiencing similar losses? How will the market view such changes?

These are only a few of the many additional consequences of IFRS that require planning. Determining how you will deal with performance measurement and the basis for valuation estimates should be a priority in your IFRS planning.

Contracts and agreements

Companies can have numerous different agreements that rely on GAAP-based financial information, like the remuneration and loan agreements noted in the above scenarios. The measurements under today's GAAP may be significantly different under IFRS, and should be revisited.

The process of revising and renegotiating contracts can be very difficult, time consuming and costly. We advise that companies and their respective stakeholders look over their agreements, ensure they're

appropriate under IFRS, and consult legal counsel to address concerns. We also advise that key performance indicators need to be reassessed.

Quality of fair value information

Assuming you've worked through the various agreements and contracts and understand how the gains and losses related to asset revaluations will be assessed, you may still have more work to do.

Incorporating a new set of accounting standards is a significant change, and even with timely advance planning, there will be uncertainty as everyone becomes familiar with what is new and untested. Unfortunately, in such periods of change the opportunity, motivation and rationalization for misuse and abuse also present themselves, and these potential risks need to be identified and controlled.

The combination of perceived opportunity, motivation and rationalization, according to Donald Cressey's fraud triangle, may lead people he refers to as "trust violators" to commit fraudulent acts (Cressey, 30-34). Depending on how you have structured your contracts or how you otherwise monitor performance, you may have unintentionally increased the motivation factor for fraudulent acts against your company (or to "assist" your company). With management also being responsible for the revaluation of assets—using their assumptions, their choice of valuers—the opportunity factor may also increase. The third element of the fraud triangle, rationalization, is what management uses to convince itself to violate trust. Rationalization may be as simple as "I deserve it," "No one will get hurt," "I won't get caught" or "everyone else is doing it."

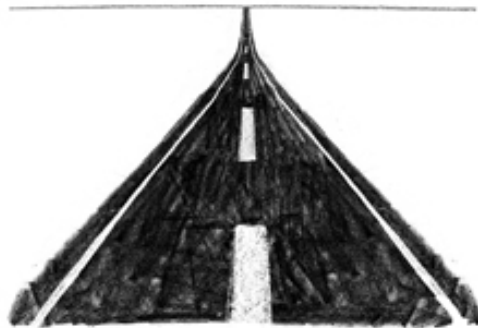
According to the Association of Certified Fraud Examiner's *2008 report to the nation*, fraudulent statements accounted for 10% of reported frauds and resulted in a median loss of \$2,000,000 (ACFE, 10-11). The report also identifies that 36% of frauds involved multiple perpetrators (e.g., collusion), with the median loss being highest amongst owner/executives and managers as perpetrators (46-49). With the fair value of assets being based on the recoverable amount, which is calculated as **either** fair value less costs to sell **or** value in use (discounted cash flow analysis based on management's assumptions), there is significant room for fraud to occur (as well as unintentional errors).

It is often the case that valuers can arrive at significantly different value estimates for businesses and assets due to differences in assumptions and sources of data. If management is estimating the fair value of an asset based on its own assumptions, how will these assumptions be validated? If management were to obtain an external valuation for assets, could they "shop around" for different values? Or, is it possible for management to simply use a fraudulent valuation (appraisal fraud)?

Companies typically make a significant investment in the quality control of financial information. With the considerable impact that asset revaluations could have on earnings or the financial position of the company, an investment in the quality of asset revaluations should also be considered. We believe that it's important for the various stakeholders of a company to ensure that a standard for the quality of these estimates is set and that the quality of these estimates is independently evaluated.

Given the increased risk for fraud in this period of change, it's important that a company's fraud risk management program be up to date. As part of this program, it will be critical that a company develop a fraud-deterrent culture to reduce the likelihood of trust violators rationalizing their fraudulent actions at the expense of stakeholders.

Planning for IFRS



Companies should consider the broader ramifications of the move to IFRS and take advantage of the time between now and its rollout to ensure that hidden risks are adequately considered and managed. An inventory of agreements that may be impacted by IFRS should be compiled, and an analysis should be performed along with legal counsel to prioritize and address issues. New performance measures that will provide better management of the company as it changes to IFRS should be defined and communicated. It's also critical that the quality of fair value estimates be addressed and standards be set to document how these estimates were determined.

How can Grant Thornton help you?

We can

- identify relevant IFRS vs. Canadian GAAP differences;
- perform detailed research;
- educate company personnel and board members;
- determine new or additional information required;
- assist in preparation of (sample) financial statements;
- scope the timing and level of effort required and undertake project management;
- review information systems to ensure IFRS readiness and assess impact on existing accounting systems;
- conduct a review of contracts: executive compensation, incentive fees, management fees;
- perform or review valuations (fair value);
- assist with the impact of deferred taxes in relation to IFRS;
- facilitate IFRS implementation;
- assist in the development of a fraud risk management program;
- supply loss quantification and litigation support services; and
- provide independent fraud investigations and forensic accounting.

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Works cited

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