

International Financial Reporting Standards



Framework-based IFRS approach

Mauritius, September 2015

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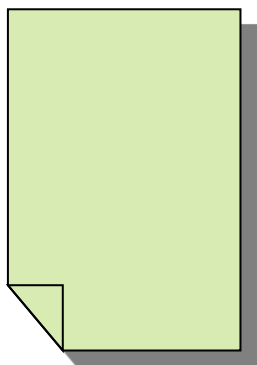
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Framework-based approach...

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- focuses on the objective of IFRS reporting
- relates IFRS requirements to underlying concepts
- develops **cohesive understanding** of IFRS
- develops ability to make **IFRS judgements**



Concepts



Principles



Rules

Framework-based approach...continued

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- What is the **economics** of the phenomenon (eg transaction, event)?
- **What information** about that economic phenomenon would primary users—existing and potential investors, lenders and other creditors that cannot demand information from the entity—find useful in making decisions about providing resources to the entity?
- Then identify the **relevant IFRS requirement/s** and evaluate the requirement/s against the objective
 - is the requirement a principle rooted in the *Conceptual Framework*?
 - if not, understand why the rule does not maximise concepts (eg application of the cost constraint, reason often in Basis for Conclusions)
- **Focus on making/auditing/regulating/analysing IFRS judgements and estimates**

Framework-based approach provides...

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- a cohesive understanding of IFRS
 - *Framework* facilitates consistent and logical formulation of IFRS
- a basis for judgement in applying IFRS
 - *Framework* established the concepts that underlie the estimates, judgements and models on which IFRS financial statements are based
- a basis for continuously updating IFRS knowledge and IFRS competencies

IFRS Foundation support

- We work with others to support *Framework*-based approach
 - create awareness
 - develop material (for examples see <http://www.ifrs.org/Use-around-the-world/Education/Pages/Framework-based-teaching-material.aspx>)
 - hold workshops (eg 2015: Abu Dhabi, Cartagena, Chicago, Dar es Salaam, Glasgow, Hong Kong, Jordan, Kiev, Lima, London, Paris, Quito, Seoul, Tokyo, Xi'an, Zimbabwe...)
 - encourage those certifying accountants to examine their students' ability to make the **judgements** that are necessary to apply IFRS

IFRS judgements

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Stage 1	Stage 2	Stage 3
Awareness	Understanding	Competence—ability to make the judgements necessary to apply IFRS

A quick reminder: main concepts underlying IFRS

*The Conceptual Framework for
Financial Reporting*

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Qualitative characteristics

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- If financial information is to be useful, it **must** be **relevant** and **faithfully represent** what it purports to represent (ie fundamental qualities).
 - Financial information without both relevance and faithful representation is not useful, and it cannot be made useful by being more comparable, verifiable, timely or understandable.
- The usefulness of financial information is enhanced if it is **comparable, verifiable, timely and understandable** (ie enhancing qualities—less critical but still highly desirable)
 - Financial information that is relevant and faithfully represented may still be useful even if it does not have any of the enhancing qualitative characteristics.

Fundamental qualitative characteristics

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- *Relevance*: capable of making a difference in users' decisions
 - predictive value (input to process to predict future cash flows)
 - confirmatory value (confirm/disconfirm prior cash flow expectations)
 - materiality (entity-specific—could affect a user's decision)
- *Faithful representation*: faithfully represents the phenomena it purports to represent
 - completeness (depiction including numbers and words)
 - neutrality (unbiased)
 - free from error (ideally)

Note: faithful representation replaces reliability

Enhancing qualitative characteristics

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- *Comparability*: like things look alike; different things look different
- *Verifiability*: knowledgeable and independent observers could reach consensus, but not necessarily complete agreement, that a depiction is a faithful representation
 - can be direct or indirect—check inputs, recalculate output
- *Timeliness*: having info in time to be capable of influencing decisions—generally older information is less useful
- *Understandability*: classify, characterise, and present information clearly and concisely

- Reporting financial information imposes costs, and it is important that those costs are justified by the benefits of reporting that information.
- In applying the cost constraint, the **IASB assesses** whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information.

Identifying elements

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Asset (see *Conceptual Framework* ¶4.4(a))

- resource controlled by the entity...
- expected inflow of economic benefits

Liability (¶4.4(b))

- present obligation...
- expected outflow of economic benefits

Equity (¶4.4(c))

- *assets – liabilities*

Income (¶4.25(a))

- recognised increase in *asset*/decrease in *liability* in current reporting period
- that result in increased equity except...

Expense (¶4.25(b))

- recognised decrease in *asset*/increase in *liability* in current period
- that result in decreased equity except...

- Recognise an asset (a liability) when:
 - **probable** that benefits will flow to (or from) the entity;
and
 - has cost or value that can **measured reliably**.

Derecognition *concept?*

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- Derecognition occurs **when** a **recognised** item is removed from the statement of financial position
- There is **no explicit concept** for derecognition in the *Conceptual Framework*. Consequently:
 - derecognition requirements are **specified at the Standards level**
 - **inconsistencies** exist between the derecognition requirements of different IFRSs
 - derecognition **does not necessarily** coincide with no longer meeting the requirements specified for **recognition**

- Measurement is the process of **determining the monetary amounts** at which the recognised elements are carried.
- IFRS measurements are largely **based on estimates, judgements and models**.
- *Conceptual Framework* currently does NOT provide concepts for measurement. It only provides a list of measurement conventions (§4.54–4.56)

- Presentation: financial statements portray financial effects of transactions and events by:
 - grouping into broad classes (eg liability)
 - sub-classifying liabilities by their nature (eg separate provisions from financial liabilities) and into current and non-current
 - analysing provisions by class
 - **not offsetting** assets and liabilities (or income and expenses)

- Objective of financial reporting
- Notes provide narrative descriptions or disaggregations of items presented in 'primary' statements and information about items that do not qualify for recognition in those statements
 - the failure to recognise an item cannot be rectified by disclosure
- Application of IFRS with additional disclosures when necessary results in a fair presentation (faithful representation of transactions, events and conditions)

Debunking common 'conceptual' misunderstandings

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Common ‘conceptual’ misunderstandings

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Myth	Clarification—the <i>Conceptual Framework</i> includes...
<i>Conceptual Framework</i> = IFRS constitution	<ul style="list-style-type: none">• <i>Conceptual Framework</i> never overrides an IFRS (see purpose and status of <i>Conceptual Framework</i>).• In absence of an IFRS, the <i>Conceptual Framework</i> is in hierarchy for developing an accounting policy (see IAS 8.11(b))

Common ‘conceptual’ misunderstandings continued

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Myth	Clarification—the <i>Conceptual Framework</i> includes...
Objective of IFRS financial information = inform entity’s tax return	Objective = provide financial information about the reporting entity that is useful to primary users—existing and potential investors, lenders and other creditors who cannot demand information directly to them—in making decisions about providing resources to the entity (eg buy, sell, hold) (¶OB 2 and OB5)

Common ‘conceptual’ misunderstandings continued

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Myth	Clarification—the <i>Conceptual Framework</i> includes...
Measured with reliability = precise	Reliability = complete, neutral and free from error (see ¶4.38)

Common ‘conceptual’ misunderstandings continued

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Myth	Clarification—the <i>Conceptual Framework</i> includes...
Matching expenses to income = underlying concept/qualitative characteristic in the Conceptual Framework	<p>Expenses are only decreases in assets/increase in liabilities in current period that result in decreased equity except...(¶4.25(b))</p> <p>Qualitative characteristics are only relevance and faithful representation (fundamental) and comparability, verifiability, timely and understandability (enhancing) (¶QC4)</p>

Common ‘conceptual’ misunderstandings continued

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Myth	Clarification—the <i>Conceptual Framework</i> includes...
Materiality is based on size alone.	Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both , of the items to which the information relates in the context of an individual entity’s financial report. (QC¶11)

Common 'conceptual' misunderstandings continued

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Myth	Clarification
An entity must account for immaterial items	Financial statements do not comply with IFRS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows (IAS 8¶41)

Common 'conceptual' misunderstandings continued

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Myth	Clarification
An entity must disclose immaterial items	An entity need not provide a specific disclosure required by an IFRS if the information is not material (IAS 1¶31)

Common ‘conceptual’ misunderstandings continued

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Myth	Clarification
Comparability = uniformity	<p>For information to be comparable, like things must look alike and different things must look different. (QC¶23)</p> <p>Making unlike things look alike does not provide information that is most useful to primary users—existing and potential investors lenders and other creditors that cannot demand information from the entity.</p>

Common ‘conceptual’ misunderstandings continued

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Myth	Clarification—the <i>Conceptual Framework</i> includes...
<p>There are two measurement bases in IFRS—historical cost and fair value</p>	<p>The Conceptual Framework describes a number of observed measurement conventions including historical cost. (¶4.54–4.56)</p> <p>Standards provide further conventions—for example net realisable value, value in use, the equity method, adjustments for hedge accounting and first time adoption. IFRS 13 provides a measurement concept—fair value.</p>

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International Financial Reporting Standards



Fair value and other cross-cutting measurement issues

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- Measurement is the process of determining monetary amounts at which elements are recognised and carried. (CF.4.54)
- To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions.
 - The *Conceptual Framework* establishes the concepts that underlie those estimates, judgements and models (CF.OB11)

- Measurement part of *Conceptual Framework* is weak
 - not concepts—a list of measurement conventions (¶4.54–4.56)
- A number of different measurement bases are employed to different degrees and in varying combinations in financial statements, including
 - historical cost
 - current cost
 - realisable (settlement) value
 - present value (CF.4.55)
- IASB guided by **objective** and **qualitative characteristics** when specifying measurements.

The objective and the qualitative characteristics

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What do you think?

objective of IFRS financial information

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Question 1—**today** the objective/s of IFRS reporting is to provide financial information about the reporting entity that is useful to?

- 1) existing and potential investors (**including the controlling shareholder**), lenders and other creditors in making resource allocation decisions (buy, sell, hold, provide loan/settle);
- 2) existing and potential investors, lenders and other creditors **who cannot require reporting entities to provide information directly to them** in making resource allocation decisions;
- 3) same as 2) PLUS a second equal objective—stewardship; or
- 4) a **broad range of users** who are not in a position to demand reports tailored to meet their particular information needs.

Objective of IFRS financial reporting

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Provide financial information about the reporting entity that is useful to **existing and potential investors, lenders and other creditors** in making decisions about providing resources to the entity (buy, sell, hold, provide loan/settle (OB 2))

...who cannot require reporting entities to provide information directly to them (OB 5)

...who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently (QC 32)

Objective of IFRS financial reporting

continued

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- Investors', lenders' and other creditors' expectations about returns depend on **their assessment** of the **amount, timing and uncertainty** of (the prospects for) **future net cash inflows** to the entity.

Qualitative characteristics

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IFRS measurements

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How many IFRS measurements? *assets*

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- Historical cost
 - initial + subsequently for unimpaired—land, inventory, indefinite life intangible assets
- Modified historical cost
 - depreciation-impairment model in IASs 16 + 38
- Fair value—IFRS 13
 - IFRSs 3 + 9 & IAS 40 + FV less cost to sell in IASs 36 + 41
- Modified fair value
 - IFRS 2 and revaluation model in IASs 16 + 38
- Others too: IAS 2 (NRV), 11, 12, 17, 29, 36 (VIU), IFRS 9 amortised cost...
- Mixture-measurement:
 - equity method and effects of hedge accounting, IFRS 1 + transitional provisions

ASSET TYPE	MEASUREMENT AT INITIAL RECOGNITION	COST MODEL	BASIS OF IMPAIRMENT TEST
IAS 2 <i>Inventory</i>	Cost of purchase and/or conversion costs and costs to get the item to the location and condition for sale	Cost unless impaired	Lower of cost (initial recognition) and net realisable value
IAS 16 <i>Property, Plant and Equipment</i>	Purchase costs + construction costs + costs to bring to the location and condition necessary to be capable of operating in the manner intended by management.	Accounting policy choice: cost less accumulated depreciation and impairment, if any	Compare carrying amount to recoverable amount. Recoverable amount is greater of value in use and fair value less disposal costs (IAS 36)
IAS 38 <i>Intangibles Assets</i>	Purchase costs + development costs + costs to bring to the location and condition necessary to be capable of operating as intended by management	Accounting policy choice: cost less accumulated amortisation (unless indefinite life asset) and impairment, if any	
IAS 40 <i>Investment Property</i>	Cost including transaction costs	Accounting policy choice: cost less accumulated depreciation (unless land) and impairment (if any)	
IFRS 9 <i>Financial Instruments</i>	Fair value	For particular business models amortised cost	IAS 39 specifies impairment rules

ASSET TYPE	MEASUREMENT AT INITIAL RECOGNITION	MODEL BASED ON FAIR VALUE	BASIS OF IMPAIRMENT TEST
IFRS 9 <i>Financial Instruments</i>	Fair value	For specified financial assets and for particular business models: fair value	
IAS 16 <i>Property, Plant and Equipment</i>	Purchase costs + construction costs + costs to bring to the location and condition necessary to be capable of operating in the manner intended by management.	Accounting policy choice: revaluation model	Compare carrying amount to recoverable amount. Recoverable amount is greater of value in use and fair value less disposal costs (IAS 36)
IAS 38 <i>Intangible Assets</i>	Purchase costs + development costs + costs to bring to the location and condition necessary to be capable of operating as intended by management	Accounting policy choice: revaluation model	
IAS 40 <i>Investment Property</i>	Cost including transaction costs	Accounting policy choice: fair value	
IAS 41 <i>Agriculture</i>	Fair value less costs to sell	Fair value less costs to sell	

LIABILITY TYPE	MEASUREMENT AT INITIAL RECOGNITION	SUBSEQUENT MEASUREMENT
IAS 12 <i>Income Taxes</i>	Deferred tax: <ul style="list-style-type: none"> - use enacted/substantively enacted tax rates - reflect the tax consequences that would follow from the manner in which the entity expects to settle the carrying amount - no discounting 	
IAS 17 <i>Leases</i>	Operating lease —not recognised Finance lease —lower of fair value of the leased property and PV of the minimum lease payments.	Operating lease —not recognised Finance lease — amortised cost using the interest rate implicit in the lease.
IAS 19 <i>Employee Benefits</i>	4 categories—3 specified measurement conventions	4 categories—3 specified measurement conventions
IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>	Best estimate of the expenditure required to settle the present obligation at the end of the reporting period.	
IFRS 3 <i>Business Combinations</i>	Fair value	N/A—other IFRSs apply
IFRS 9 <i>Financial Instruments</i>	Fair value	It depends: Amortised cost (effective interest method), Fair value for derivatives + other financial liabilities in specified circumstances
IFRS 15 <i>Revenue</i>	Customer consideration but..	Customer consideration but...
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Historical cost

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Historical cost?

the 'concept' ¶4.55(a)

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The historical cost of an asset is:

- the amount of cash or cash equivalents paid; **or**
- the fair value of the consideration given to acquire it at the time of its acquisition.

Historical cost?

example 1

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Scenario 1: today you receive (and gain control of) a new machine in exchange for cash 100.

What is the cost of the machine?—choose 1 of:

1) *100*

2) *121*

3) *150*

Historical cost?

example 1 continued

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Scenario 2: today you receive (and gain control of) a new machine in exchange for a promise to pay 121 two years later. (Assume market interest rate = 10%)

What is the cost of the machine?—choose 1 of:

1) 100

2) 121

3) 150

Historical cost?

example 1 continued

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Scenario 3: today you pay 100 cash in exchange for a promise to receive (and gain control of) a new machine two years later. Two years later when you receive the machine, its fair value = 150. (market interest rate = 10%)

What is the cost of the machine?—choose 1 of:

1) 100

2) 121

3) 150

Historical cost?

example 2 (see IFRS IC March 2015)

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Today you receive (and gain control of) a new machine. You paid FCU100 to the supplier of the machine:

Scenario 1: today when spot rate is $\text{FCU}100 = \text{CU}100$

What is the cost of the machine?—choose 1 of: (1)90 (2)100

Scenario 2: 1 month earlier when $\text{FCU}100 = \text{CU}90$ and prepayment is a monetary asset (non-performance = FCU refund)

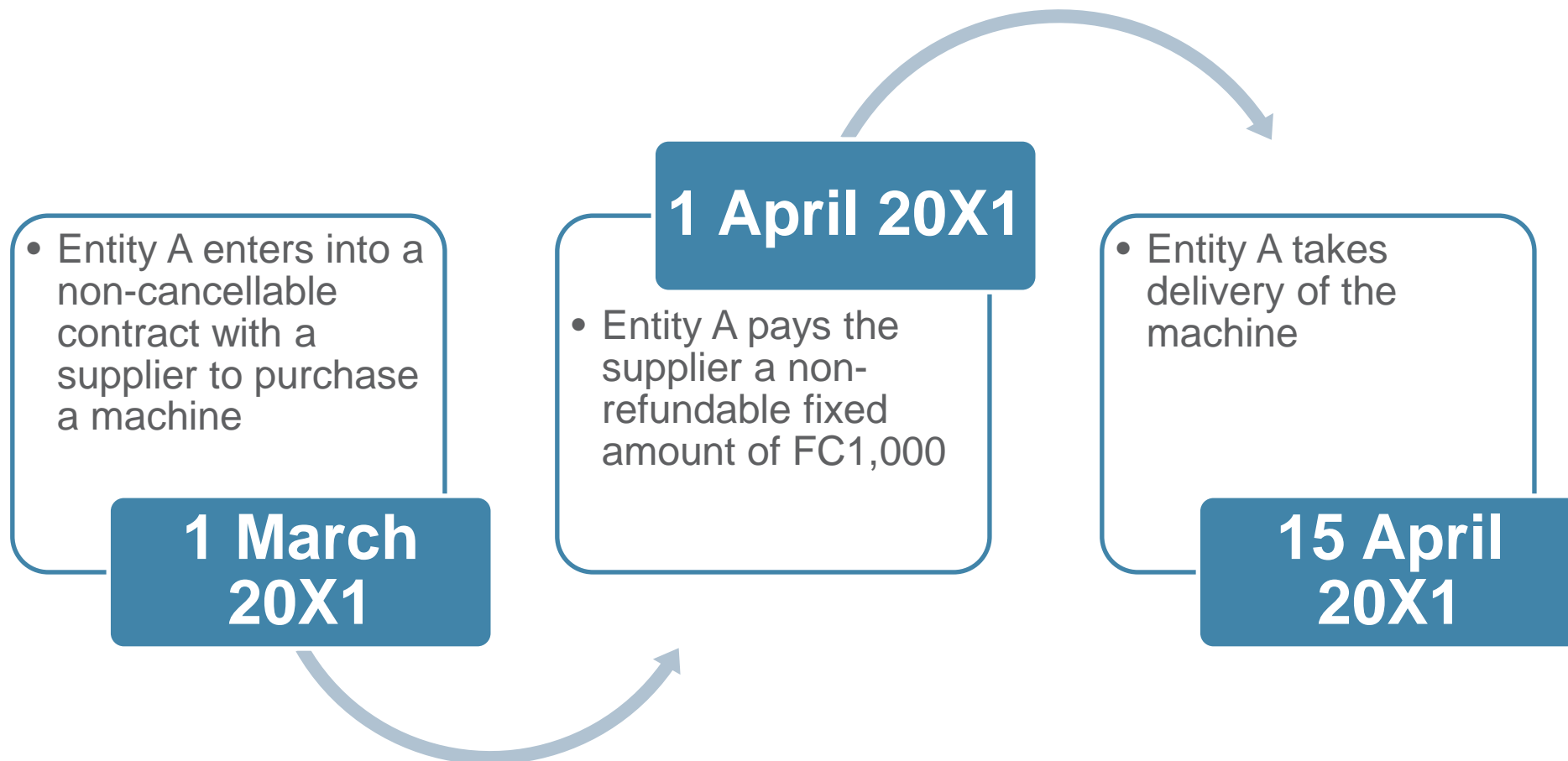
What is the cost of the machine?—choose 1 of: (1)90 (2)100

Scenario 3: 1 month earlier when $\text{FCU}100 = \text{CU}90$ and prepayment is a non-monetary asset

What is the cost of the machine?—choose 1 of: (1)90 (2)100

Example - single advance payment for the purchase of a single item of property, plant and equipment

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Cost-based IFRS measurements

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- Few things measured at historical cost
 - unimpaired land (IAS 16 + IAS 40 cost model)
 - unimpaired indefinite life intangibles (IAS 38)
 - unimpaired inventories (IAS 2)
- Cost-based measurements are more common
 - unimpaired depreciated historic cost (IAS 16)
 - unimpaired amortised historical cost (IAS 38)
 - amortised cost (IFRS 9)

With the passage of time, cost-based measurements become increasingly irrelevant. (IAS.40.B33(b))

Allocating depreciation: concepts

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- Information about an entity's financial performance in a period, reflected by changes in economic resources (eg PPE) is useful in assessing the entity's past and future ability to generate net cash inflows (CF.OB18)
- Expenses are decreases in economic benefits during an accounting period in the form of depletions of assets... (CF.4.25)
- Depreciation represents the consumption of the asset's service potential in the period.

Depreciation

example 1: the concept

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‘Concept’—depreciation represents the consumption of the asset’s service potential in the period.

When is land (classified as PPE) depreciated?

- (1) never—its service potential does not reduce with time/use*
- (2) always—its service potential always reduces with time/use*
- (3) when its recoverable amount declines below its unmodified historical cost (for example, when market prices decline)*
- (4) when its service potential is consumed through use (for example, when used as a landfill site).*

Allocating depreciation: the principle

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- Depreciation is the **systematic allocation** of the **depreciable amount** of an asset over its **useful life** (IAS16.6).
 - essentially a cost allocation technique (IAS16.BC29)
- Systematic allocation (application guidance):
 - **Depreciation method** must closely reflects the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
 - **Unit of measure** for depreciation is different from an item of PPE. By depreciating significant parts of an item of PPE separately, depreciation more faithfully represents the consumption of the assets service potential. (IAS16.BC26)

Allocating depreciation: application guidance (1)

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- Depreciable amount =
 - cost model: historical cost less residual value
 - revaluation model: fair value less residual value
- Residual value =
 - amount that the entity would currently obtained from disposal of asset (less estimated disposal costs) if the asset were already of the age and in the condition expected at the end of its useful life

Allocating depreciation: application guidance (2)

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- Useful life (entity specific) =
 - the period over which the asset is expected to be available for use by the entity; or
 - the number of production or similar units expected to be obtained from the asset by the entity.
- Consequently, depreciation **continues when idle** (if useful life = period)
- However, depreciation **ceases when classified as held for sale** because IFRS 5 measurement is essentially a process of valuation, rather than allocation (IFRS5.BC29)

Depreciation

example 2: Judgements and estimates

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Entity A acquires a commercial spacecraft:

- Cost €100m - capacity to make 150 voyages to outer-space
- Legal restrictions require mandatory decommissioning at earlier of 100 voyages or 5 years
- Management forecasts that the spacecraft will make: 5 voyages in Year (Y) 1; 15 in Y2; 20 in Y3; and 60 in Y4
- Management expects income per voyage to halve each year as the 'novelty factor' of recreational space travel fades
- Entity A could sell the spacecraft at the end of its useful life for approx. €10 million but intends to destroy it to protect the technologies in it (estimate costs of destroying = €1 million)
- Craft must pass inspection before starting commercial travel, and subsequently every 2 years. First inspection cost €20 million
- Management plans to replace the craft's soft furnishings after 50 flights. Cost of soft furnishings is approx. €100,000

Depreciation

example 2: components continued

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*Question 1: Must any **components** of the spacecraft be depreciated separately?*

(a) No

(b) Yes, the inspection component must be depreciated separately from the other components of the spacecraft (ie 2 components)

(c) Yes, the inspection component and the soft furnishings component must each be depreciated separately from the other components (ie 3 components)

Depreciation

example 2: depreciation method continued

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Question 2: Which depreciation method must be used for the spacecraft?

(a) Management free to choose a depreciation method

(b) Straight line method for both the inspection component and other component

(c) Units of production method for both the inspection component and other component

(d) Revenue-based depreciation for both the inspection component and other component

(e) Straight-line for the inspection component and units of production (based on the number of flights) for other component

Depreciation

example 2: residual value continued

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Question 3: Which of the alternatives below indicates an estimate of the **residual value** of spacecraft at 31/12/20Y0?

- a) Nil
- b) €10 million
- c) €10 million less expected costs of disposal
- d) Amount would get on 31/12/20Y0 less estimated costs of disposal, if already 5 years old and in the condition expected at the end of 20Y5
- e) Amount would get on 31/12/20Y0 less estimated costs of disposal, if already flown 100 flights and in condition expected after 100 flights
- f) Present value of €10 million less estimated costs of disposal

Question 4: At 31/12/20Y0 spacecraft's useful life is?

- a) 100 voyages for entire spacecraft*
- b) 150 voyages for entire spacecraft*
- c) 4 years for entire spacecraft*
- d) 5 years for entire spacecraft*
- e) Service component = 2 years and Other component = 150 voyages*
- f) Service component = 2 years and Other component = 100 voyages*
- g) Service component = 2 years and Other component = 4 years*

Fair value measurement

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What is fair value?

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- Fair value is the price that would be received to sell an asset or paid to transfer a liability (*exit price*) in an **orderly transaction** (*not a forced sale*) between market participants (*market-based view*) at the measurement date (*current price*). (see IFRS 13)
- Fair value is a market-based measurement (it is not an entity-specific measurement)
 - consequently, the entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

Examples— *measurement ‘economics’*

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- Why did the Board conclude that it would be highly unlikely that an entity can justify a change in accounting policy for investment property from the fair value model to the cost model?
- Why did the Board conclude that fair value measurement was most appropriate measurement attribute for biological assets in agricultural activity?

Examples— *measurement ‘economics’* continued

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(August 2013) Excerpts from *EBay-Style Lender Has Better Way of Keeping Books* by Jonathan Weil Bloomberg View columnist (see <http://www.bloombergtview.com/articles/2013-08-27/ebay-style-lender-has-better-way-of-keeping-books>)

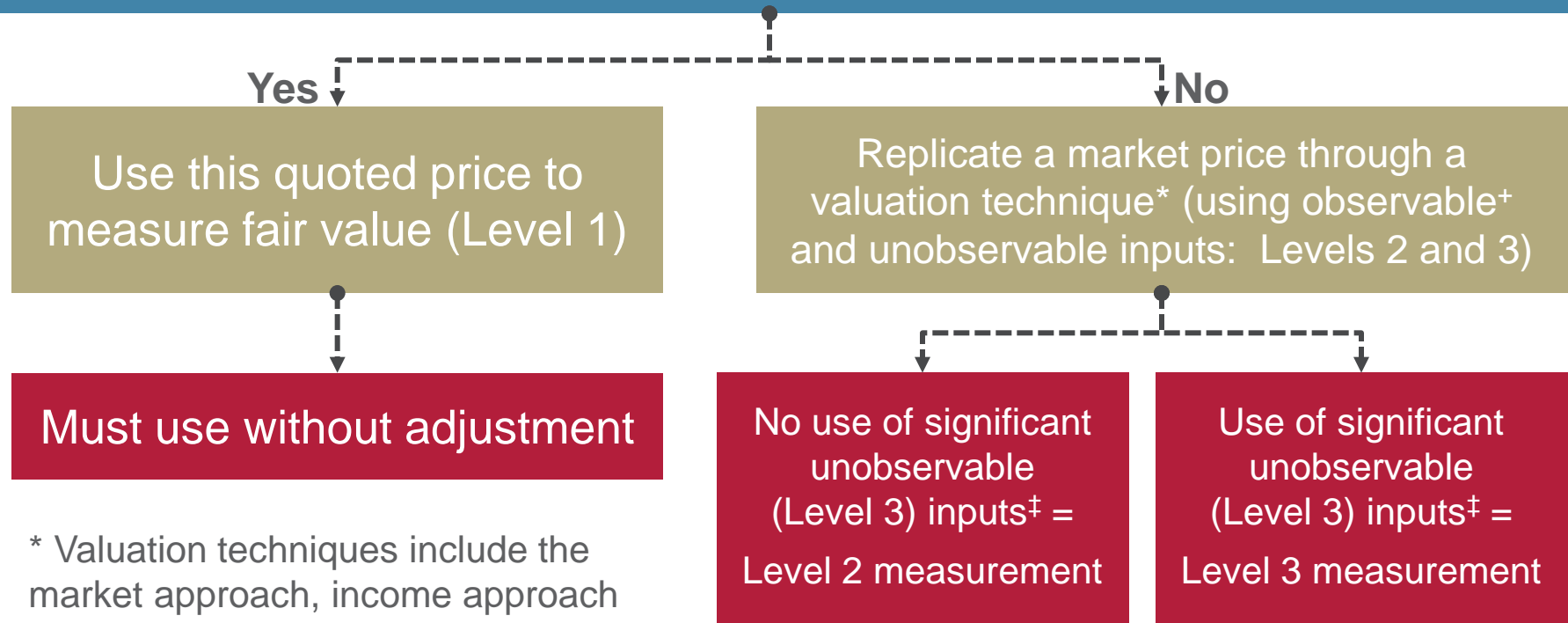
- “The company matches individual borrowers with money from outside investors -- hence, the terms “peer to peer” or “EBay-style loans.” The loans go on the company's books as assets, while the notes and similar instruments that it sells to investors are recorded as liabilities.”
- “Why did LendingClub elect fair-value accounting for its loans? In short, it **reflects the economics** of its transactions better than using historical cost would.”
- “Sure, an investor might look at those Level 3 disclosures and say yuck. But that's the point: Investors can see them and make up their own minds. The reality is that the **historical-cost numbers on others lenders' books are problematic, too**. It's just as difficult to come up with estimates for future loan losses and reserves as it is to gauge market values for loans.”

Measuring fair value

application guidance

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Is there a quoted price in an active market for an identical asset or liability?



* Valuation techniques include the market approach, income approach and cost approach.

+ Maximise the use of *relevant* observable inputs and minimise the use of unobservable inputs. Observable inputs include market data (prices and other information that is publicly available).

‡ Unobservable inputs include the entity's own data (budgets, forecasts) which must be adjusted if market participants would use different assumptions.

Non-financial assets

highest and best use

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- Fair value assumes a non-financial asset is used by market participants at its **highest and best use**
 - the use of a non-financial asset by market participants that maximises the value of the asset
 - physically possible
 - legally permissible
 - financially feasible

Non-financial assets

example 1

73

For generations your family farms apples in rural farmland that your great-grandfather purchased for 1. Today:

- the fair value of the land with fruit-bearing trees = 50
- if vacant, the fair value of the farmland would be 20

What is the fair value of the fruit-bearing trees?

Choose 1 of: (1)50 (2)30 (3)20 (4)0 (5)*another amount*

Non-financial assets

example 2: scenario 1

74

For generations your family farms apples in **Berlin** on farmland that your great-grandfather purchased for 1.

Today:

- the fair value of the land with fruit-bearing trees = 100
- if vacant, the fair value of the farmland would also be 100

Scenario 1: you revalue farmland (ie revaluation model)

What is the fair value of the fruit-bearing trees?

Choose 1 of: (1)100 (2)30 (3)23 (4)0 (5)another amount

Non-financial assets

example 2: scenario 2

75

For generations your family farms apples in **Berlin** on farmland that your great-grandfather purchased for 1.

Today:

- fair value of the farmland with fruit-bearing trees = 100
- if vacant, fair value of the farmland would also = 100

Scenario 2: you do not revalue farmland (ie cost model)

What is the fair value of the fruit-bearing trees?

Choose 1 of: (1)100 (2)30 (3)23 (4)0 (5)another amount

**Now what about the judgements
necessary to measure such fair value?**

Non-financial assets

example 3: a regulatory ruling

77

Anglo-Eastern Plantations Plc (the company) for the year ended 31 December 2010

“The Conduct Committee’s Financial Reporting Review Panel (FRRP) considered the company’s **use of historical rather than current data to estimate the fair value of palm oil trees**, recognised in the balance sheet as biological assets. In its 2010 accounts the company valued its plantation estates using a discounted cash flow technique by estimating future sales proceeds of palm oil, deducting from this the estimated cash costs of production and discounting these estimated net cash flows. The company used historical percentages to allocate the plantation estate values between land, palm oil trees and equipment. However, an allocation on **this basis does not achieve fair value** for the biological asset, as required by IAS 41 ‘Agriculture’.” (emphasis added)

Non-financial assets

example 3: a regulatory ruling continued

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“In its 2012 accounts, whilst the FRRP’s enquiries were on-going, the company changed its valuation method to value land and biological assets separately and recorded its first prior year restatement. Land was valued by reference to market prices. The fair value of palm oil trees was valued using a similar discounted cash flow technique to the plantation estate method. However, the **estimated cash costs of production used historical, rather than current data, to estimate the cost of using the land** on which the palm oil trees are planted. As a consequence, **the fair value of biological assets was over-stated.**”

Following further discussion with the FRRP, the company has used current market data to estimate the cost for the use of land in its discounted cash flow. This has given rise to a second prior period restatement, announced by the company today, that reduced the value of its biological assets at December 2012 by \$37 million from \$245 million to \$208 million. Profit after tax for the year ended 31 December 2012 was reduced by \$1.6 million. There was no impact on cash.” (emphasis added)

Example 4—legally permissible

79

You own a plot of land in Greater London that is currently zoned 'green belt'—currently planning permission would not be granted to put the land to a use other than agriculture (its current use). The price at which the land could be sold at 31/12/20x1 is:

- **Scenario (S)1** if the land was now zoned for the construction of **high-rise buildings**: price = CU100,000,000;
- **S2** if market participants believed there was **no prospect of the zoning laws changing**: price = CU1,000,000

Example 4—legally permissible continued

80

Recent sales of similar neighbouring plots subject to the same zoning restrictions increased from CU2,000,000 two months ago to CU3,000,000 on 31/12/20x1 when to the Government unexpectedly announced it is considering relaxing the restrictions on green belt land.

In the absence of other relevant factors at 31/12/20x1 what is the fair value of your plot?

- (1) CU100,000,000 (if already rezoned for high-rise development)
- (2) CU3,000,000 (price for similar asset on measurement date)
- (3) CU2,500,000 (recent average sale price for similar assets)
- (4) CU2,000,000 (lowest recent price for similar asset)
- (5) CU1,000,000 (zoned agricultural use only)

Fair value of assets

judgements and estimates

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- When using the most recent market transaction price to measure fair value: identifying the most recent market transaction price and evaluating whether economic circumstances have changed significantly.
- When using market prices for similar assets: adjusting the prices to reflect differences.
- When using sector benchmarks (eg the value of cattle expressed per kilogram of meat): adjusting to reflect differences.
- When using DCF model: estimating the expected future net cash inflows and the discount rate.

Liability measurement

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not necessarily those of the IASB or IFRS Foundation

Amortised cost

trade creditor: 'interest free' credit

83

- 1/1/20x1 purchase goods for CU1,210 on 2-year interest-free credit. Cash sale price = CU1,000.
- Effective interest rate (IRR) = 10%.

Amortised cost

interest free' credit continued

84

Journal entries		Debit	Credit
1/1/20x1	Asset: inventory	1,000	
	Liability: trade creditor		1,000
31/12/20x1	Expense: finance cost	100	
<i>10% x 1,000</i>	Liability: trade creditor		100
31/12/20x2	Expense: finance cost	110	
<i>10% x 1,100</i>	Liability: trade creditor		110
1/1/20x3	Liability: trade creditor	1,210	
<i>1,000 + 100 + 110</i>	Asset: cash		1,210

What does 'best estimate' mean?

85

The principle—the amount that an entity would rationally pay to:

- (i) settle the obligation at the end of the reporting period;
or
- (ii) to transfer it to a third party at that time

Best estimate *measuring expected value*

86

Outcome	Estimated outflows	Relative likelihood
Best case	CU 100	
Most likely outcome	CU 200	About twice as likely as best case
Worst case	CU 1,000	Unlikely, but possible

Estimate of expected value	
CU 100 x 30%	CU 30
CU 200 x 60%	CU 120
CU 1,000 x 10%	<u>CU 100</u>
	<u>CU 250</u>

Risk adjustments?

Do expected
values take
account of risk?

Entity-specific IFRS measurements

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not necessarily those of the IASB or IFRS Foundation

Examples of entity-specific IFRS measurements include:

- net realisable value (IAS 2)
- value in use (IAS 36)
- Non-controlling interest using alternative measurement to fair value (IFRS 3)
- onerous contract (IAS 37)

IAS 2 *Inventories*—example 1

net realisable value, raw material

90

At reporting date:

- carrying amount (cost) of raw materials = CU100
- replacement cost = CU80
- fair value = CU75; cost to sell raw material would = CU1
- expected selling price of finished good = CU180
- expected cost to convert the raw material into finished good = CU60
- expected costs to sell the finished good = CU30

The net realisable value of the raw material is? Choose 1 of:

*(1) CU180; (2) CU150; (3) CU120; (4) CU100; (5) CU90;
(6) CU80; (7) CU75; or (8) CU74.*

Net realisable value (IAS 2)

judgements and estimates

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- Identifying impaired inventories (unsaleable, damaged, price changes—selling price, costs to convert and costs to sell)
- Measuring net realisable value involves estimating:
 - selling price;
 - costs to complete; and
 - costs to sell.

IAS 36 *Impairment of Assets* *an overview*

92

- Scope—when to test for impairment?
- Impairment testing level—individual asset or cash generating unit (CGU) or (for goodwill) group of CGUs? What about corporate assets?
- Impairment test: estimate the recoverable amount (RA) of the asset and impair asset if its carrying amount (CA) > RA.
Impairment expense (income from reversal of impairment) is recognised in profit or loss.
- What about goodwill and corporate assets?

Note: if impairment indicated review the remaining useful life, the depreciation (amortisation) method or the residual value for the asset even if no impairment loss found.

IAS 36 *Impairment of Assets*

scope

93

- In scope of IAS 36 unless asset covered by another IFRS (eg inventories).

IAS 36 *Impairment of Assets*

when to test for impairment?

94

- At reporting date **assess whether** there is any indication that an asset may be impaired.
If any such indication exists perform impairment test (IAS 36 ¶9).
- Irrespective of whether there is any indication of impairment: (IAS 36 ¶10) test for impairment:
 - **at the same time each year** (and whenever impairment is indicated) **goodwill, indefinite life intangible asset** or an intangible assets **not yet available for use**; and
 - such assets must be tested for impairment in the year of their acquisition.

Consider, as a minimum:

- **External sources of information**
 - asset's market value declined significantly > expected
 - significant changes in the technological, market, economic or legal environment
 - market rates increased (eg effect on discount rate)
 - CA of the net assets > estimated fair value of the entity
- Internal sources of information

Consider, as a minimum:

- External sources of information
- **Internal sources of information**
 - obsolete or physical damaged asset
 - significant changes in the extent or manner in which, an asset is (or is expected to be) used
 - eg idle assets, plans to discontinue or restructure operation, plans to dispose before expected, and reassessing the useful life from indefinite to finite
 - internal reporting indicates that the economic performance of an asset is, or will be, worse than expected

IAS 36 *Impairment of Assets*

impairment testing level

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- Principle: test for impairment at the individual asset level (see IAS 36 ¶66).
- However: if impossible to estimate the recoverable amount of an individual assets then determine the recoverable amount of the **cash-generating unit (CGU)** to which it relates (see IAS 36 ¶66). CGU is the is the smallest identifiable group of assets that generates cash inflows that are largely independent of the cash inflows from other assets or groups of assets.
- Nevertheless, **goodwill** is tested for impairment at the **lowest level at which it is monitored** for internal management purposes provided that level is not larger than an operating segment as defined in IFRS 8 (see IAS 36 ¶80)

IAS 36 *Impairment of Assets*

impairment test

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- Impairment test
 - estimate the recoverable amount (RA) of the asset
 - impair if carrying amount (CA) > RA and recognise impairment loss in profit or loss.

IAS 36 *Impairment of Assets*

recoverable amount

99

- Recoverable amount = higher of value in use (VIU) and fair value less costs to sell (FV-CTS)
 - if either VIU or FV-CTS > CA then no need to determine the other
 - if no reason to believe VIU > FV-CTS, then FV-CTS may be used as RA

IAS 36 *Impairment of Assets*

estimating value in use

100

- VIU = present value of the future net cash flows expected to be derived from an asset.
- Steps to calculate VIU:
 - estimate **future cash flows** (in and out) from continuing use of the asset and its ultimate disposal, and
 - apply appropriate **discount rate** to future cash flows

IAS 36 *Impairment of Assets*

estimating value in use continued

101

- Reflect in calculation of VIU:
 - est. future cash flows (FCFs) entity expects
 - expectations about possible variations in the amount or timing of those FCFs
 - time value of money (current market risk-free rate of interest)
 - price for uncertainty inherent in the asset
 - other factors (eg illiquidity) that market participants would adjust for
- Avoid double-counting in FCFs and discount rate

IAS 36 *Impairment of Assets*

value in use cash flows

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- Estimates of FCFs include:
 - **cash inflows** from the continuing use
 - **cash outflows** necessary to generate cash inflows (directly attributed or allocated on reasonable and consistent basis)
 - net cash flows, if any, expected from **disposal** at end of useful life
- May:
 - use recent budgets/forecasts to est. cash flows
 - extrapolate beyond forecast period using steady or declining growth rate, unless another is justified

IAS 36 *Impairment of Assets*

value in use cash flows continued

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- Est. FCFs for asset in current condition
- Est. FCFs don't include in/outflows from:
 - a future restructuring to which an entity is not yet committed, or
 - improving or enhancing the asset's performance.
- Est. FCFs also don't include:
 - cash in/outflows from financing activities, and
 - income tax receipts/payments.

IAS 36 *Impairment of Assets*

individual asset impairment and reversal

104

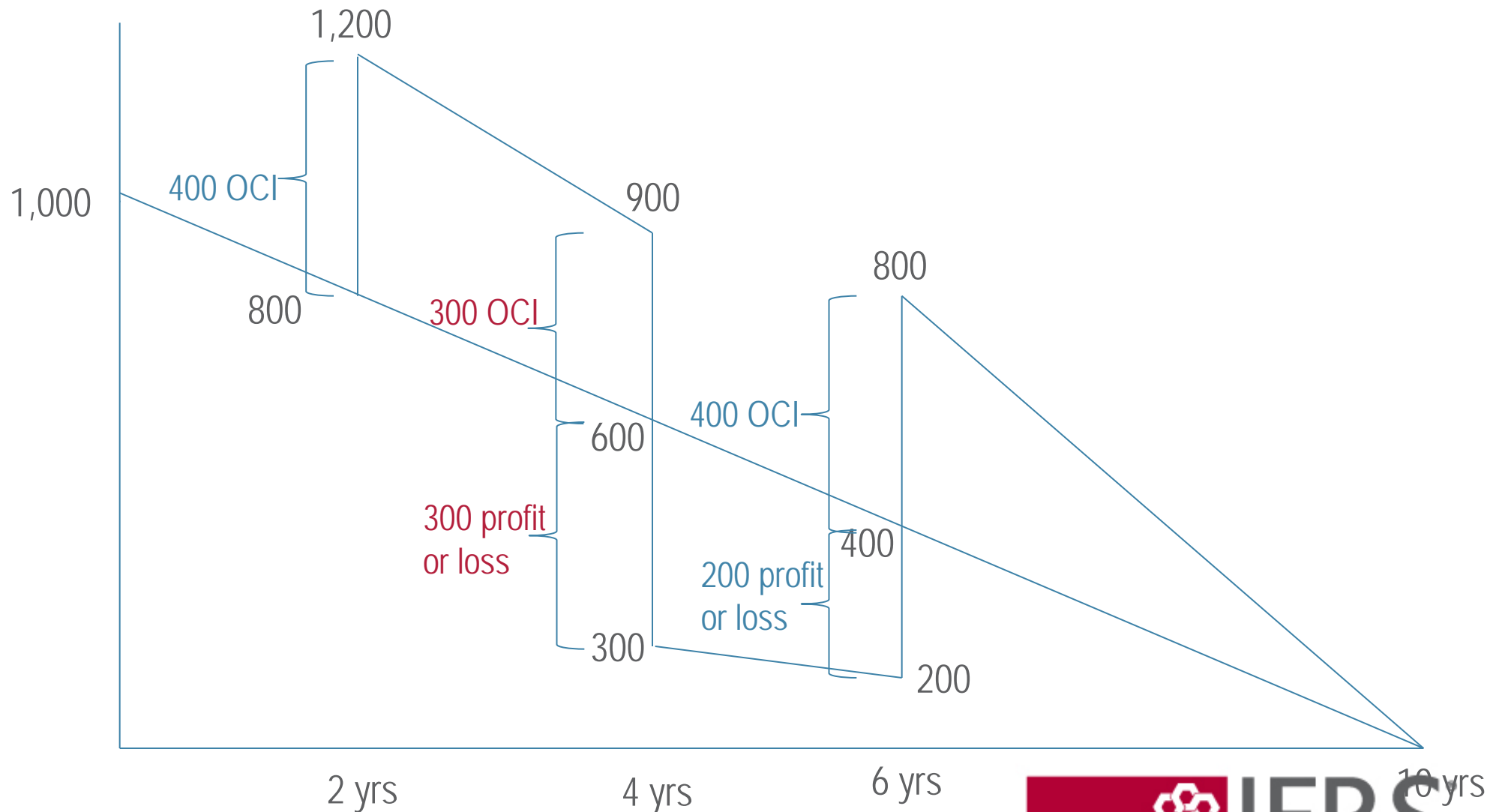
Example 1:

- 01/01/20x1 entity Z buys a machine
 - cost = CU1,000
 - useful life = 10 years
 - depreciation method = straight-line
 - nil residual value
- 31/12/20x2 revalue machine to CU1,200 (fair value)
- 31/12/20x4 the recoverable amount = CU300
- 31/12/20x6 revalue machine to CU800 (fair value)

IAS 36 *Impairment of Assets*

individual asset impairment and reversal conti.

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IAS 36 *Impairment of Assets*

CGU allocating impairment loss

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- Allocate impairment loss:
 - 1st to any **goodwill** allocated to the cash-generating unit (CGU)
 - 2nd to **other assets pro rata** on the basis carrying amount of each asset in CGU
 - However, cannot reduce the carrying amount of any asset below the highest of 0, FV-CTS and VIU (if determinable)
 - reallocate to other assets of CGU

IAS 36 *Impairment of Assets*

CGU impairment loss

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Example 2:

- At 31/12/20x1 carrying amount of a CGU's assets = CU210 (ie CU150 taxis, CU50 taxi licence and CU10 goodwill)
- Impairment indicated; recoverable amount = CU170.
- Fair value of taxis = CU140.

Allocate impairment loss to CGU's assets, as follows:

- Impairment loss = CU40 (ie CU210 CA less CU170 RA)
- 1st allocate CU10 loss to goodwill
- 2nd allocate remaining CU30 loss, ie CU22.5 to taxis and CU7.5 to licence (pro rata on CA)
- 3rd reallocate CU12.5 loss from taxis to licence

IAS 36 *Impairment of Assets*

reverse impairment loss

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Example 2 extended—reversal of impairment loss

- Facts from Example 2. At 31/12/20x2 CA of CGU = CU120 (ie CU100 taxis and CU20 licence)
- Impairment reversal indicated and RA estimated = CU150

Allocate impairment loss reversal to CGU's assets, as follows:

- Potential impairment reversal = CU30 (ie CU150 RA less CU120 CA) but limited to CU20 (as follows):
 - 1st allocate to assets pro rata on CAs, ie CU5 to licence and CU25 to taxis
 - 2nd limit amount allocated to taxis to CU7 (if no impairment in 20x1, CA at 20x2 = CU107)

IAS 36 *Impairment of Assets*

reverse impairment loss continued

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Example 2 extended continued

- 3rd reallocate CU18 reversal from taxis to licence
- Total reversal provisionally allocated to licence = CU23 (ie CU5 + CU18)
- 4th limit amount allocated to licences to CU13 (if no impairment in 20x1, CA at 20X2 = CU33)
- 5th as there are no other assets to reallocate the unallocated CU10 (ie CU23 less CU13) reversal to, limit the total impairment reversal to CU20 (ie CU7 for taxis and CU13 for licence)

IAS 36 *Impairment of Assets*

after reversal

110

- After reversing impairment loss
- Adjust the depreciation/amortisation charge for the asset in future periods to allocate the asset's revised CA, less its residual value (if any), on a systematic basis over its remaining useful life

IAS 36 *Impairment of Assets*

goodwill and NCI

111

- If NCI is not accounted for at fair value at acquisition in accordance with the alternative in IFRS 3, then carrying amount of partly-owned CGU is notionally adjusted for the NCI's share of goodwill before being compared with its recoverable amount.

IAS 36 *Impairment of Assets*

example: goodwill and NCI

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Example 3:

- Goodwill of CU80 on A's acquisition of 75% of B's shares on 1/1/20X1.
- To reflect synergies the group allocated the goodwill:
 - CU50 to A's CGU; and
 - CU30 to B's CGU.
- For impairment testing purposes only B's goodwill is notionally grossed up to 40 (ie 'additional' goodwill and NCI = 10).

IAS 36 *Impairment of Assets*

value in use judgements and estimates

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- Identifying internal and external indicators of impairment
- Identifying cash-generating units (CGUs)
- Allocating assets (eg goodwill) to CGUs
- Measuring recoverable amount at the higher of an asset/CGU's value in use (VIU) and its fair value less costs to sell
- Measuring VIU:
 - estimate future cash flows (in and out) from continuing use of the asset and its ultimate disposal, and
 - determine appropriate discount rate to apply to future cash flows
 - etc

IAS 37 re onerous contracts

judgements and estimates

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- Identifying onerous contracts, ie when the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received under it.
 - The unavoidable costs under a contract reflect the least net cost of exiting from the contract, which is the lower of the cost of fulfilling it and any compensation or penalties arising from failure to fulfil it.
- Estimates include:
 - estimating cash inflows (benefits) from fulfilling the contract and determining appropriate discount rate/s
 - measuring future unavoidable costs of fulfilling contract
 - estimating default compensation/penalties..

Thank you

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individual comments
view
expressions
feedback a
question
expressions of individual vie
individual comments
questions or
individual
comments
expressions of
individual views
questions
individual
comments
questions or
expressions of individual views
questions or individual comments
feedback
questions
feedback
questions
expressions of individual views
questions and viewpoints
feedback and comments



Root causes of financial reporting anomalies

Mauritius, September 2015

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Panel members

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Donna Street

- *International Association for Accounting Education and Research (IAAER)*

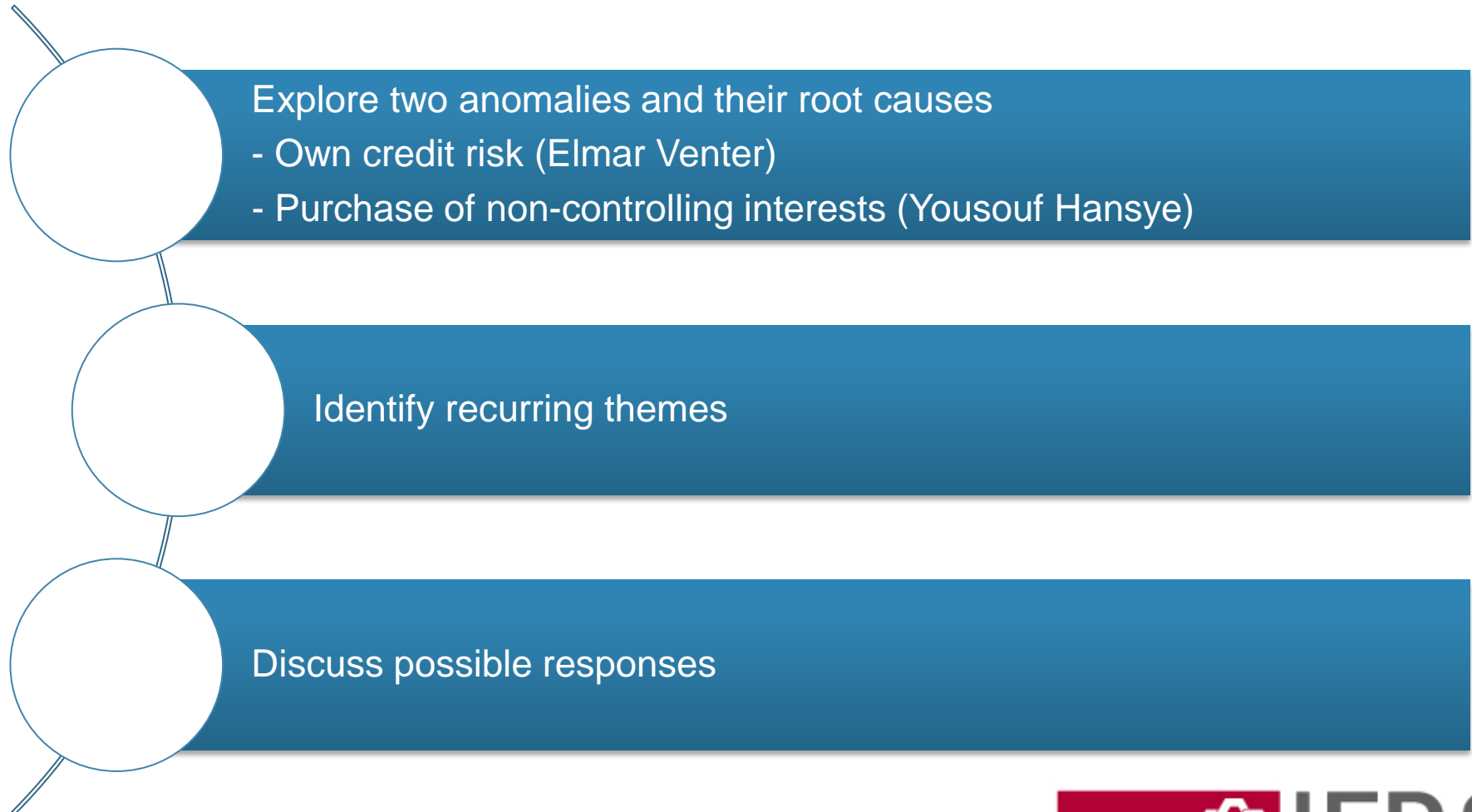
Elmar Venter

- *International Association for Accounting Education and Research (IAAER)*

Yousouf Hansye

- *Project Manager, IFRS Education Initiative, International Accounting Standards Board*

- Raise awareness of issues that are criticised in practice, and explore their root causes to:
 - help people teaching accounting know where there are accounting anomalies
 - help students understand these and become better preparers, auditors and users of financial statements
- Inform all who respond to standard setting invitations to comment
- Get feedback about how standard setters should respond to these criticisms



Accounting for a change in own credit risk

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Downgraded credit rating

Accounting

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When an entity measures its own debt at FVTPL, a decrease in its fair value is accounted for as follows:

<i>DR:</i>	<i>Financial liabilities</i>	<i>XXXX</i>
<i>CR:</i>	<i>Income</i>	<i>XXXX</i>

Is it a counterintuitive 'accounting gimmick' that the downgrading of own credit rating results in recognising income in the period of the downgrade from the measurement of liabilities carried at fair value?

Choose 1 of:

(a) yes

(b) no

(c) it depends—what is the business model?

What does the media say?

Accounting continued

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Bank Profits From Accounting Rules

By Yalman Onaran - June 5, 2009 00:01 EDT

Another \$2.7 billion before taxes came from an accounting rule that lets a company record income when the value of its own debt falls. That reflects the possibility a company could buy back bonds at a discount, generating a profit. In reality, when a bank can't fund such a transaction, the gain is an accounting quirk, Weiss says.



EUROPEAN CENTRAL BANK

Doubts are also raised with regard to the application of FVA to the *liability* side of banks. For instance, the suggested methodology (the so-called “own credit risk”) to determine the fair value of debt instruments issued by banks entails that, if the rating of a bank deteriorates, the value of its equity will ultimately increase (since the difference in revaluation of debt instruments is accounted in the profit and loss account). This outcome is counter-intuitive and can be misleading for shareholders and creditors.

Downgraded credit rating

the economics continued

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Assume: An entity issues CU1,000,000 on 21 January 20x2 to repay in full after 10 years when the market rate of interest at which the entity can issue was 5%.

Fair value: CU613,913

Assume: On 22 January 20x2 the entity's credit rating deteriorates and the market rate of interest at which the entity can issue debt is 10%.

Fair value: CU385,543

Downgraded credit rating

the economics continued

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Assume: on 22 January 20x2 entity pays CU385,543 to repurchase the debt it issued on 20 January 20X2 for CU613,913.

Economically how much has entity lost/gained?

Choose 1 of:

(a) gain (income) CU228,370

(b) loss (expense) CU228,370

(c) nil

Would your answer about the economics change if entity had not repurchased its debt? Why or why not?

[see IFRS 9.BCZ5.31]

Downgraded credit rating

IFRS requirements continued

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Assume: on 22 January 20x2 entity pays CU385,543 to repurchase the debt it issued on 20 January 20X2 for CU613,913.

*How much income/expense **must** entity recognise ito IFRS?*

Choose 1 of:

- (a) income CU228,370*
- (b) expense CU228,370*
- (c) nil*

Downgraded credit rating

IFRS *requirements* continued

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Assume: on 20 January 20x2 entity issues debt for CU613,913. On 22 January the debt is trading actively at CU385,543. Entity does not repurchase it.

*How much income/expense **must** entity recognise ito IFRS?*

Choose 1 of:

(a) income CU228,370

(b) expense CU228,370

(c) nil

(d) income CU228,370 if entity carries this liability at FV; otherwise nil.

TBTF Case Study:

On 21/01/20x2 TBTF's credit rating is downgraded:

- Market cap: CU50 billion decrease
- Accounting entries:
 - Decrease in FV of own debt at FVTPL: CU10 billion (income)
 - [50% of debt measured at FV and 50% at amortised cost]
 - Decrease in FV of financial assets at FVTPL: CU8 billion (expense)
 - Fixed asset impairment: CU12 billion (expense)

Downgraded credit rating *the economics*

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- The economics:

Equity	=	Assets	Min	Liabilities
50	=	?	-	20
50	=	70	-	20

- IFRS:

Equity	=	Assets	Min	Liabilities
?	=	20	-	10
10	=	20	-	10

— Why is IFRS different to the economics?

Research—fair value accounting for liabilities and own credit risk

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Barth, Hodder, and Stubben, *The Accounting Review* 2008

TABLE 2
Regression of Returns on Debt Interacted with Credit Risk Change
(n = 49,081)

$$RET_t = \beta_0 + \beta_1 \Delta CR_t + \beta_2 \Delta CR_t \times DBTA_t + \beta_3 DBTA_t + \beta_4 EPS_t + \beta_5 \Delta EPS_t + \beta_6 NEG_t + \beta_7 NEG_t \times EPS_t + \beta_8 NEG_t \times \Delta EPS_t + \varepsilon_{4t}$$

Panel A: Pooled Credit Risk Effects

	Pred.	Coef.	t-statistic	DBTA Ranks	
				Coef.	t-statistic
ΔCR	—	−0.11	−19.56	−0.13	−18.02
$\Delta CR \times DBTA$	+	0.19	10.24	0.12	9.75
$DBTA$?	−0.07	−7.82	−0.04	−7.32
EPS	+	1.89	72.11	1.90	72.25
ΔEPS	+	0.43	26.03	0.43	26.02
NEG	—	−0.12	−23.43	−0.12	−23.59
$NEG \times EPS$	—	−1.80	−57.10	−1.80	−57.12
$NEG \times \Delta EPS$	—	−0.28	−13.19	−0.29	−13.31
Adj. R ²		0.17		0.17	

Research—fair value accounting for liabilities and own credit risk

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Barth, Hodder, and Stubben, *The Accounting Review* 2008

Untabulated statistics reveal that for approximately 73 percent (27 percent) of downgrade firms, recognized asset write-downs are larger (smaller) than unrecognized gains from decreases in debt value. This suggests the concern that debt value decreases would exceed recognized contemporaneous asset value decreases is unwarranted (warranted) for a large majority (substantial minority) of downgrade firms.

TABLE 8
Descriptive Statistics using Merton Model Estimates, Separately for
Upgrades and Downgrades
(n = 19,118)

Panel A: Distributional Statistics by Change in Credit Risk

	Downgrades (n = 1,719)			Upgrades (n = 1,626)			No Change (n = 15,773)		
	Mean	Median	Std. Dev.	Mean	Median	Std. Dev.	Mean	Median	Std. Dev.
$\Delta NI_t - \Delta UD_t$	-0.10	-0.07	0.25	0.08	0.05	0.23	-0.00	0.00	0.23

Controlling interest buys NCI

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not necessarily those of the IASB or IFRS Foundation

Controlling interest buys NCI

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Anomaly: controlling shareholder's equity reduces (and return on equity increases) when controlling shareholder pays fair value to buy out the NCI.

What are investors saying?

Warren Buffett (2013) "nonsensical accounting rule that I described in last year's letter required that we enter these purchases on our books at \$1.8 billion less than we paid, a process that reduced Berkshire's book value... This weird accounting, you should understand, instantly increased Berkshire's excess of intrinsic value over book value by the same \$1.8 billion."

*Dennis Jullens, UBS (2010)
"This accounting adjustment caused return on equity to increase from 17% in 2008 to 119% in 2009... (p68)
However, the principal reason for Roche's return on equity is accounting rather than underlying economics."*

Controlling interest buys NCI continued

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Transaction: group pays CU10 billion to buy out NCI.

Economics: group pays CU10 billion to settle NCI's CU10 billion claim.

IFRS 10 accounting:

Debit Equity: NCI (book value of claim extinguished) CU4 billion

Credit Asset: cash (money left the group) (CU10 billion)

∴ Debit Equity (transaction between equity holders) CU6 billion

What's the problem? The carrying amount/book value of NCI was measured at CU4 million which is less than its economic value CU10 million.

Why does this happen? Although NCI was initially measured at its fair value, it is subsequently remeasured based on group accounting for its subsidiary.

NCI is not measured at its economic value.

Purchase NCI

what could be done?

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Which, if any, of the hypothetical changes to IFRS below, do you believe would address Warren Buffet's concerns?

- (a) *each reporting period* remeasure NCI and underlying items to fair value.
- (b) *only on the date NCI purchased*—remeasure NCI and underlying items to fair value.
- (c) *rather than remeasuring NCI at its fair value, when NCI is purchased create a new asset measured at the difference between the fair value and the carrying amount of the NCI purchased (ie in the Example CU10 billion – CU4 billion = CU6 billion asset). What's the 'new' asset?*

Summary—some root causes of financial reporting anomalies

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- Element existence
 - Not recognising items that satisfy the definition of an asset or a liability. For example, in-process research, internally generated brands, some 'forward' contracts
 - Recognising 'assets'/'liabilities' for items that do not satisfy the definition of an asset/definition of a liability. For example, some government grants
- Measurement inconsistencies
 - Mixed measurements (historical cost, partially updated, fair value)
 - Not updating for new data
- Splitting presentation of changes between P&L and OCI

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The word cloud features the words 'questions', 'comments', 'view', 'expressions of', and 'individual' in various sizes and orientations. The words are arranged in a way that they appear to be floating or scattered, with some words appearing more frequently than others. The colors are primarily shades of blue, green, and yellow, with some words in white. The background is a solid light blue.