Framework-based IFRS approach
Mauritius, September 2015

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**Framework-based approach...**

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

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**Concepts**  
**Principles**  
**Rules**
Framework-based approach...continued

• 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...

- 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)
  - encourage those certifying accountants to examine their students’ ability to make the judgements that are necessary to apply IFRS
Framework-based approach IFRS material language map and workshops

- **Comprehensive teaching material**: Languages—Arabic, Chinese, English, French (stage 3 only), Korean (in 2015), Japanese, Polish (stage 3 only), Portugese, Russian and Spanish.
- **'Train the teacher' workshop**: number indicates duration in days.
- **Half-day video conference**
- **Regional IFRS regulatory capacity building workshops**: number indicates duration in days.
# IFRS judgements

<table>
<thead>
<tr>
<th>Stage 1</th>
<th>Stage 2</th>
<th>Stage 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Awareness</td>
<td>Understanding</td>
<td>Competence—ability to make the judgements necessary to apply IFRS</td>
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</table>
A quick reminder: main concepts underlying IFRS

The Conceptual Framework for Financial Reporting
Qualitative characteristics

• If financial information is to be useful, it must be **relevant** and **faithfully represent** what it purports to represent (i.e. 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** (i.e. 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

- **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

• **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
Cost constraint

• 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

**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...
Recognition

• 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?

• 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

• 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

- 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)
Disclosure

- 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
## Common ‘conceptual’ misunderstandings

<table>
<thead>
<tr>
<th>Myth</th>
<th>Clarification—the Conceptual Framework includes…</th>
</tr>
</thead>
<tbody>
<tr>
<td>Conceptual Framework = IFRS constitution</td>
<td></td>
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</tbody>
</table>
  
  
  - In absence of an IFRS, the Conceptual Framework is in hierarchy for developing an accounting policy (see IAS 8.11(b)) |
### Myth Clarification—the Conceptual Framework includes…

<table>
<thead>
<tr>
<th>Myth</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Objective of IFRS financial information = inform entity’s tax return</td>
<td>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)</td>
</tr>
<tr>
<td>Myth</td>
<td>Clarification—the Conceptual Framework includes…</td>
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<tr>
<td>-----------------------------</td>
<td>--------------------------------------------------</td>
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<tr>
<td>Measured with reliability = precise</td>
<td>Reliability = complete, neutral and free from error (see ¶4.38)</td>
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</table>
### Myth Clarification—the Conceptual Framework includes...

<table>
<thead>
<tr>
<th>Myth</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Matching expenses to income = underlying concept/qualitative characteristic in the Conceptual Framework</td>
<td>Expenses are only decreases in assets/increase in liabilities in current period that result in decreased equity except…(¶4.25(b)) Qualitative characteristics are only relevance and faithful representation (fundamental) and comparability, verifiability, timely and understandability (enhancing) (¶QC4)</td>
</tr>
<tr>
<td>Myth</td>
<td>Clarification—the Conceptual Framework includes…</td>
</tr>
<tr>
<td>------</td>
<td>--------------------------------------------------</td>
</tr>
<tr>
<td>Materiality is based on size alone.</td>
<td>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)</td>
</tr>
</tbody>
</table>
### Myth Clarification

<table>
<thead>
<tr>
<th>Myth</th>
<th>Clarification</th>
</tr>
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<tbody>
<tr>
<td>An entity must account for <strong>immaterial</strong> items</td>
<td>Financial statements do not comply with IFRS if they contain either <strong>material</strong> errors or <strong>immaterial</strong> errors made intentionally to achieve a particular presentation of an entity’s financial position, financial performance or cash flows (IAS 8¶41)</td>
</tr>
<tr>
<td>Myth</td>
<td>Clarification</td>
</tr>
<tr>
<td>----------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
</tr>
<tr>
<td>An entity must disclose <strong>immaterial</strong> items</td>
<td>An entity <strong>need not</strong> provide a specific disclosure required by an IFRS if the information is not material (IAS 1¶31)</td>
</tr>
</tbody>
</table>
### Myth Clarification

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<thead>
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<th>Clarification</th>
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<td>Comparability = uniformity</td>
<td>For information to be comparable, like things must look alike and different things must look different. (QC ¶23)</td>
</tr>
<tr>
<td></td>
<td>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.</td>
</tr>
</tbody>
</table>
## Common ‘conceptual’ misunderstandings continued

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<tr>
<th>Myth</th>
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</tr>
</thead>
<tbody>
<tr>
<td>There are two measurement bases in IFRS—historical cost and fair value</td>
<td>The Conceptual Framework describes a number of observed measurement conventions including historical cost. (¶4.54–4.56) 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.</td>
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Measurement ‘concepts’

- 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 ‘concepts’ continued

• 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
What do you think?
objective of IFRS financial information

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

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

• 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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International Financial Reporting Standards

IFRS measurements

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How many IFRS measurements?

**assets**

- **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
<table>
<thead>
<tr>
<th>ASSET TYPE</th>
<th>MEASUREMENT AT INITIAL RECOGNITION</th>
<th>COST MODEL</th>
<th>BASIS OF IMPAIRMENT TEST</th>
</tr>
</thead>
<tbody>
<tr>
<td>IAS 2 Inventory</td>
<td><strong>Cost</strong> of purchase and/or conversion <strong>costs</strong> and <strong>costs</strong> to get the item to the location and condition for sale</td>
<td><strong>Cost</strong> unless impaired</td>
<td>Lower of <strong>cost</strong> (initial recognition) and net realisable value</td>
</tr>
<tr>
<td>IAS 16 Property, Plant and Equipment</td>
<td>Purchase <strong>costs</strong> + construction <strong>costs</strong> + <strong>costs</strong> to bring to the location and condition necessary to be capable of operating in the manner intended by management.</td>
<td>Accounting policy choice: <strong>cost</strong> less accumulated depreciation and impairment, if any</td>
<td>Compare carrying amount to recoverable amount. Recoverable amount is greater of value in use and fair value less disposal costs (IAS 36)</td>
</tr>
<tr>
<td>IAS 38 Intangibles Assets</td>
<td>Purchase <strong>costs</strong> + development <strong>costs</strong> + <strong>costs</strong> to bring to the location and condition necessary to be capable of operating as intended by management</td>
<td>Accounting policy choice: <strong>cost</strong> less accumulated amortisation (unless indefinite life asset) and impairment, if any</td>
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<tr>
<td>IAS 40 Investment Property</td>
<td><strong>Cost</strong> including transaction costs</td>
<td>Accounting policy choice: <strong>cost</strong> less accumulated depreciation (unless land) and impairment (if any)</td>
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<tr>
<td>IFRS 9 Financial Instruments</td>
<td>Fair value</td>
<td>For particular business models <strong>amortised cost</strong></td>
<td>IAS 39 specifies impairment rules</td>
</tr>
<tr>
<td>ASSET TYPE</td>
<td>MEASUREMENT AT INITIAL RECOGNITION</td>
<td>MODEL BASED ON FAIR VALUE</td>
<td>BASIS OF IMPAIRMENT TEST</td>
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<td>IFRS 9 Financial Instruments</td>
<td><strong>Fair value</strong></td>
<td>For specified financial assets and for particular business models: <strong>fair value</strong></td>
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<td>IAS 16 Property, Plant and Equipment</td>
<td>Purchase costs + construction costs + costs to bring to the location and condition necessary to be capable of operating in the manner intended by management.</td>
<td>Accounting policy choice: <strong>revaluation model</strong></td>
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<td>IAS 40 Investment Property</td>
<td>Cost including transaction costs</td>
<td>Accounting policy choice: <strong>fair value</strong></td>
<td></td>
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<tr>
<td>IAS 41 Agriculture</td>
<td><strong>Fair value</strong> less costs to sell</td>
<td><strong>Fair value</strong> less costs to sell</td>
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<tr>
<td>LIABILITY TYPE</td>
<td>MEASUREMENT AT INITIAL RECOGNITION</td>
<td>SUBSEQUENT MEASUREMENT</td>
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<tr>
<td>IAS 12 <em>Income Taxes</em></td>
<td>Deferred tax:</td>
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<tr>
<td></td>
<td>- use enacted/substantively enacted tax rates</td>
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<td>- reflect the tax consequences that would follow from the manner in which the entity expects to set</td>
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<td>tle the carrying amount</td>
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<tr>
<td></td>
<td>- no discounting</td>
<td></td>
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<tr>
<td>IAS 17 <em>Leases</em></td>
<td><strong>Operating lease</strong>—not recognised</td>
<td><strong>Operating lease</strong>—not recognised</td>
<td></td>
</tr>
<tr>
<td></td>
<td><strong>Finance lease</strong>—lower of fair value of the leased property and PV of the minimum lease payments.</td>
<td><strong>Finance lease</strong>—amortised cost using the interest rate implicit in the lease.</td>
<td></td>
</tr>
<tr>
<td>IAS 19 <em>Employee Benefits</em></td>
<td>4 categories—3 specified measurement conventions</td>
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<td></td>
</tr>
<tr>
<td>IAS 37 <em>Provisions, Contingent Liabilities and Contingent Assets</em></td>
<td><strong>Best estimate</strong> of the expenditure required to settle the present obligation at the end of the reporting period.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>IFRS 3 <em>Business Combinations</em></td>
<td><strong>Fair value</strong></td>
<td>N/A—other IFRSs apply</td>
<td></td>
</tr>
<tr>
<td>IFRS 9 <em>Financial Instruments</em></td>
<td><strong>Fair value</strong></td>
<td>It depends: <strong>Amortised cost</strong> (effective interest method), <strong>Fair value</strong> for derivatives + other financial liabilities in specified circumstances</td>
<td></td>
</tr>
<tr>
<td>IFRS 15 <em>Revenue</em></td>
<td>Customer consideration but..</td>
<td>Customer consideration but…</td>
<td></td>
</tr>
</tbody>
</table>
Historical cost
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

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
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
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)

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 FCU100 = CU100
What is the cost of the machine?—choose 1 of: (1)90 (2)100

Scenario 2: 1 month earlier when FCU100 = CU90 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 FCU100 = CU90 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

- Entity A enters into a non-cancellable contract with a supplier to purchase a machine

1 March 20X1

- Entity A pays the supplier a non-refundable fixed amount of FC1,000

1 April 20X1

- Entity A takes delivery of the machine

15 April 20X1
Cost-based IFRS measurements
Cost-based IFRS measurements

• 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

- Information about an entity’s financial performance in a period, reflected by changes in economic resources (e.g., 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

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

When is land (classified as PPE) depreciated?

(1) never—it’s service potential does not reduce with time/use
(2) always—it’s 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).
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 reflect 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)

- 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
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

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
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)
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 |
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
What is fair value?

• 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’

- 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?

- “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

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

Yes

Use this quoted price to measure fair value (Level 1)

Must use without adjustment

No

Replicate a market price through a valuation technique* (using observable+ and unobservable inputs: Levels 2 and 3)

No use of significant unobservable (Level 3) inputs‡ = Level 2 measurement

Use of significant unobservable (Level 3) inputs‡ = Level 3 measurement

* 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*

• 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

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

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
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
Non-financial assets

Now what about the judgements necessary to measure such fair value?
**Non-financial assets**

**example 3: a regulatory ruling**

**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)
“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

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
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

• 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 (e.g., 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
Amortised cost

trade creditor: ‘interest free’ credit

• 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

<table>
<thead>
<tr>
<th>Journal entries</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>1/1/20x1</td>
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<tr>
<td>Asset: inventory</td>
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<td>Liability: trade creditor</td>
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<td>31/12/20x1</td>
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<td></td>
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<tr>
<td>Liability: trade creditor</td>
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<td></td>
</tr>
<tr>
<td>31/12/20x2</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expense: finance cost</td>
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<td></td>
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<td></td>
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<tr>
<td>Liability: trade creditor</td>
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<tr>
<td>1/1/20x3</td>
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<td></td>
</tr>
<tr>
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<td></td>
</tr>
<tr>
<td>1,000 + 100 + 110</td>
<td>1,210</td>
<td></td>
</tr>
<tr>
<td>Asset: cash</td>
<td>1,210</td>
<td></td>
</tr>
</tbody>
</table>
What does ‘best estimate’ mean?

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

<table>
<thead>
<tr>
<th>Outcome</th>
<th>Estimated outflows</th>
<th>Relative likelihood</th>
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<tbody>
<tr>
<td>Best case</td>
<td>cu 100</td>
<td></td>
</tr>
<tr>
<td>Most likely outcome</td>
<td>cu 200</td>
<td>About twice as likely as best case</td>
</tr>
<tr>
<td>Worst case</td>
<td>cu 1,000</td>
<td>Unlikely, but possible</td>
</tr>
</tbody>
</table>

### Estimate of expected value

<table>
<thead>
<tr>
<th>Estimation of expected value</th>
<th>cu 100 x 30%</th>
<th>cu 200 x 60%</th>
<th>cu 1,000 x 10%</th>
<th>cu 100</th>
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<tbody>
<tr>
<td></td>
<td>cu 30</td>
<td>cu 120</td>
<td>cu 100</td>
<td>cu 250</td>
</tr>
</tbody>
</table>
Risk adjustments?

Do expected values take account of risk?
Entity-specific IFRS measurements
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)
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

• 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

• 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**

- In scope of IAS 36 unless asset covered by another IFRS (eg inventories).
IAS 36 Impairment of Assets
when to test for impairment?

• 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

• 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

• 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

• 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

• 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
• 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
• 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

• 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.
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
CGU allocating impairment loss

- 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

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
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)
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

- 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
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.
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

• 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
• 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..

**IAS 37 re onerous contracts**

**judgements and estimates**
Thank you
Root causes of financial reporting anomalies
Mauritius, September 2015
Panel members

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
Objective

• 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
Panel structure

Explore two anomalies and their root causes
- Own credit risk (Elmar Venter)
- Purchase of non-controlling interests (Yousouf Hansye)

Identify recurring themes

Discuss possible responses
Accounting for a change in own credit risk
When an entity measures its own debt at FVTPL, a decrease in its fair value is accounted for as follows:

DR: Financial liabilities XXXX
CR: Income XXXX
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?
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.

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.
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
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]
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
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 into 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.
Downgraded credit rating

the economics

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)
• The economics:

<table>
<thead>
<tr>
<th>Equity</th>
<th>=</th>
<th>Assets</th>
<th>Min</th>
<th>Liabilities</th>
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<tr>
<td>50</td>
<td>=</td>
<td>?</td>
<td>-</td>
<td>20</td>
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<td>50</td>
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• IFRS:

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<td>10</td>
<td>=</td>
<td>20</td>
<td>-</td>
<td>10</td>
</tr>
</tbody>
</table>

– Why is IFRS different to the economics?
Research—fair value accounting for liabilities and own credit risk


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

<table>
<thead>
<tr>
<th></th>
<th>Pred.</th>
<th>Coef.</th>
<th>t-statistic</th>
<th>DBTA Ranks</th>
</tr>
</thead>
<tbody>
<tr>
<td>ΔCR</td>
<td>−</td>
<td>−0.11</td>
<td>−19.56</td>
<td>−0.13</td>
</tr>
<tr>
<td>ΔCR × DBTA</td>
<td>+</td>
<td>0.19</td>
<td>10.24</td>
<td>0.12</td>
</tr>
<tr>
<td>DBTA</td>
<td>?</td>
<td>−0.07</td>
<td>−7.82</td>
<td>−0.04</td>
</tr>
<tr>
<td>EPS</td>
<td>+</td>
<td>1.89</td>
<td>72.11</td>
<td>1.90</td>
</tr>
<tr>
<td>ΔEPS</td>
<td>+</td>
<td>0.43</td>
<td>26.03</td>
<td>0.43</td>
</tr>
<tr>
<td>NEG</td>
<td>−</td>
<td>−0.12</td>
<td>−23.43</td>
<td>−0.12</td>
</tr>
<tr>
<td>NEG × EPS</td>
<td>−</td>
<td>−1.80</td>
<td>−57.10</td>
<td>−1.80</td>
</tr>
<tr>
<td>NEG × ΔEPS</td>
<td>−</td>
<td>−0.28</td>
<td>−13.19</td>
<td>−0.29</td>
</tr>
<tr>
<td>Adj. R²</td>
<td></td>
<td>0.17</td>
<td></td>
<td>0.17</td>
</tr>
</tbody>
</table>
Research—fair value accounting for liabilities and own credit risk

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

<table>
<thead>
<tr>
<th></th>
<th>Downgrades (n = 1,719)</th>
<th>Upgrades (n = 1,626)</th>
<th>No Change (n = 15,773)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Mean</td>
<td>Median</td>
<td>Std. Dev.</td>
</tr>
<tr>
<td>$\Delta NI_t - \Delta UD_t$</td>
<td>$-0.10$</td>
<td>$-0.07$</td>
<td>$0.25$</td>
</tr>
</tbody>
</table>
Controlling interest buys NCI
Controlling interest buys NCI

**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.”
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 \((\text{book value of claim extinguished})\) \(\text{CU4 billion}\)

Credit Asset: cash \((\text{money left the group})\) \((\text{CU10 billion})\)

.: Debit Equity \((\text{transaction between equity holders})\) \(\text{CU6 billion}\)

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.
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

- 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
Thank you