UNCTAD-ISAR and IFRS Foundation
Accounting Education Forum

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Afternoon Session

Capacity-building in corporate financial reporting: Framework-based teaching of International Financial Reporting Standards

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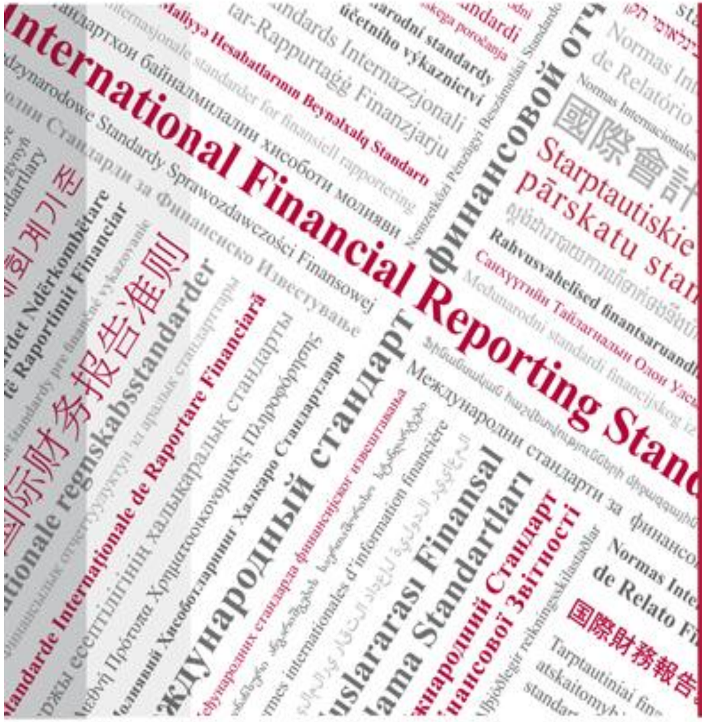
International Financial Reporting Standards



Framework-based teaching non-financial assets

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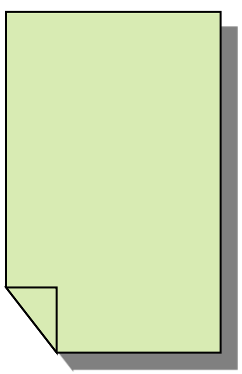
Framework-based IFRS teaching…

- relates the IFRS requirements being taught to the concepts in *Conceptual Framework*
- explains why some IFRS requirements do not maximise those concepts (eg application of the cost constraint or inherited requirements)



Concepts

Principles

Rules

Framework-based teaching provides…

- a cohesive understanding of IFRSs
  - *Framework* facilitates consistent and logical formulation of IFRSs
- a basis for judgement in applying IFRSs
  - *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

Role of the *Conceptual Framework*

- **IASB** uses *Framework* to set standards
  - enhances consistency across standards
  - enhances consistency across time as Board members change
  - provides benchmark for judgments
- **IFRS Interpretations Committee** uses *Framework* to interpret IFRSs when there is no IFRS requirement
- **Preparers** use *Framework* to develop accounting policies in the absence of specific standard
  - IAS 8 hierarchy

  This workshop demonstrates the role of the *Framework* in IFRS teaching

The IASB's *Conceptual Framework*

- *Framework* sets out agreed concepts that underlie IFRS financial reporting
  - the objective of general purpose financial reporting
  - qualitative characteristics
  - elements of financial statements
  - recognition
  - measurement
  - presentation and disclosure

Other concepts all flow from the objective

Objective of 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

Objective of financial reporting

- 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.
  - Decisions by investors about buying, selling or holding equity and debt instruments depend on the returns that they expect from an investment in those instruments, eg dividends, principal and interest payments or market price increases.
  - Decisions by lenders about providing or settling loans and other forms of credit depend on the principal and interest payments or other returns that they expect.

Objective of financial reporting

- To assess an entity's prospects for future net cash inflows, existing and potential investors, lenders and other creditors need information about:
  - the resources of the entity;
  - claims against the entity; and
  - how efficiently and effectively the entity's management and governing board have discharged their responsibilities to use the entity's resources
    - eg protecting the entity's resources from unfavourable effects of economic factors such as price and technological changes

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Qualitative characteristics

- 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)

Fundamental qualitative characteristics

- *Relevance*: capable of making a difference in users' decisions
  - predictive value
  - confirmatory value
  - materiality (entity-specific)
- *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'

Example: materiality

- A large listed profitable manufacturer
  - financial statements in millions of CUs
  - recognises individual items of PPE that cost less than CU1,000 as an expense on initial recognition
  - In 20X1 this policy resulted in CU100,000 being recognised as an expense

Does the Entity's policy contravene IFRSs (Discuss)?

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
- *Timeliness*: having information available to decision-makers in time to be capable of influencing their decisions
- *Understandability*: Classify, characterise, and present information clearly and concisely

Examples:
errors & changes in policies and estimates

- Objective
- Concepts
  - relevant and faithful representation
  - comparability
- Principle
  - Prior period error: retrospective restatement
  - Change in policy: retrospective application
  - Change in estimate: prospective application
- Rules
  - impracticable exception
  - transitional provisions (new requirements)
  - specified disclosures

Pervasive constraint

- Reporting financial information imposes costs.
- IASB assesses whether the benefits are likely to justify the costs (quantitative and qualitative information)
  - Benefits include more efficient functioning of capital markets and a lower cost of capital for the economy.
  - Costs include collecting, processing, verifying and disseminating financial information and the costs of analysing and interpreting the information provided.

Pervasive constraint

- It is consistent with the *Conceptual Framework* for an IFRS requirement not to maximise the qualitative characteristics of financial information when the costs of doing so would exceed the benefits.

Elements—concepts

Asset

- resource controlled by the entity
- result of past event
- expected inflow of economic benefits

Liability

- present obligation
- arising from past event
- expected outflow of economic benefits

Equity = assets less liabilities

Income

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

Expense

- recognised decrease in asset/increase in liability in current reporting period
- that result in decreased equity except…

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Assets

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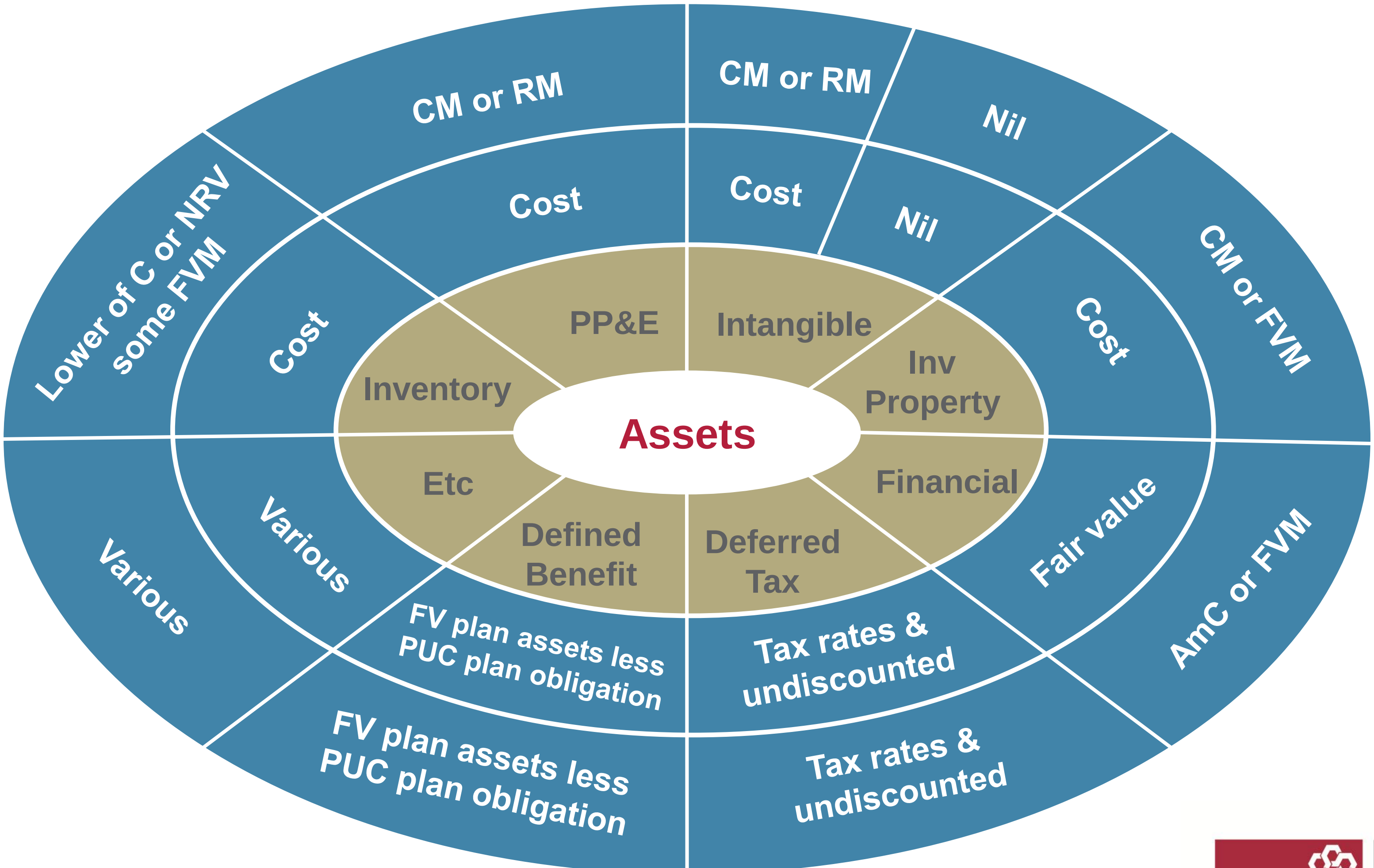
Assets overview



Examples—identifying assets

Are the following items assets?

- An electricity generator's nuclear plant operating under onerous government imposed rules the breach of which would result in immediate closure.
- An oil explorer's deep sea drilling rig. ±10% probability of discovering oil. If no oil found then no income.

Examples—identifying assets
continued

Are the following items assets?

- Fish in the sea, short-term rental of fishing equipment and fishing licence (from a fish harvester's perspective)
- A fish farmer's fish tanks and breeding stock

Asset classification (which IFRS applies?)

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Classification concepts

- Objective of financial reporting
- Financial statements portray financial effects of transactions and events by:
  - grouping into broad classes (the elements, eg asset)
  - sub-classify elements (eg assets sub-classified by their nature or function in the business)
- IAS 1
  - application of IFRSs with additional disclosures when necessary results in a fair presentation (faithful representation of transactions, events and conditions)
  - do not offset assets & liabilities or income & expenses

Classification concepts—assets

- Different types of economic resources affect a user’s assessment of the reporting entity's prospects for future cash flows differently.
  - some future cash flows result directly from existing economic resources (eg accounts receivable and investment property).
  - other cash flows result from using several resources in combination to produce and market goods or services to customers (eg PPE and intangible assets). Although those cash flows cannot be identified with individual economic resources (or claims), users of financial reports need to know the nature and amount of the resources available for use in a reporting entity’s operations. (CF.OB14)

Classification of assets

- Different assets exhibit different characteristics (nature) and can be held for a variety of uses (use) in order to generate future economic benefits
- Nature and use determine the classification of assets
- IFRSs defines a number of assets
- For some assets significant judgement is required to determine their classification

Non-financial asset type

ASSET TYPE	USE IN BUSINESS?	FORM OF FUTURE ECONOMIC BENEFITS
Inventory (IAS 2)	Sale or used in production of items for sale or in services	Usually cash or other asset received in exchange
PPE (IAS 16)	Used in production or supply of goods or services, rental or administration (more than one period)	Usually cash through sale of 'final' product or service
Intangibles (IAS 38)	Used in production or supply of goods or services	Usually cash through sale of 'final' product or service
Investment property IAS 40)	Earn rentals or capital appreciation, or both	Usually cash inflows independent from other assets
Biological asset in agricultural activity (IAS 41)	To generate cash returns or as a hedging instrument	Usually cash or other asset received in exchange for harvested products or sale of progeny

Examples: asset classification

Which IFRS classification of asset?

- investment in ordinary shares
- gold
- land
- land planted with plantation
- a mushroom farmer’s growing mushrooms
- mules used to carry supplies
- owner-occupied building held for sale
- owner-occupied building decided to abandon

Judgements and estimates (IAS 40)

- It can be difficult to determine whether particular biological assets are engaged in agricultural activity and therefore in the scope of IAS 41—eg the animals of some zoos.
- Sometimes it is difficult to identify investment property (IAS 40). In such cases an entity develops criteria so that it can exercise that judgement consistently
  - eg, owner of a hotel transfers some responsibilities to third parties under a management contract (PPE or investment property?)

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Asset recognition concepts

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Asset recognition concepts

An asset is recognised when:

- it is **probable** that any future economic benefit associated with the item will flow to the entity; and
- the item has a cost or value that can be measured with **reliability**.

For some items that satisfy the definition of an asset, significant judgement is required to evaluate whether such items satisfy the recognition criteria. Individual IFRSs provide principles and application guidance.

Recognition questions

What does probable mean?

The meaning of probable is determined at the standards level. Therefore, inconsistent use across IFRSs

What does measure reliably mean?

To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions.

Recognition of internally generated intangible assets (IAS 38)

- It is sometimes difficult to assess whether an internally generated intangible asset qualifies for recognition because of problems in:
    a. identifying whether and when there is an identifiable asset that will generate expected future economic benefits; and
    b. determining the cost of the asset reliably. In some cases, the cost of generating an intangible asset internally cannot be distinguished from the cost of maintaining or enhancing the entity's internally generated goodwill or of running day-to-day operations.
- Therefore, special requirements in addition to the general requirements for recognition of an internally generated intangible asset apply.

Recognition of research costs (IAS 38)

- Expenditure on particular internally generated intangible assets must be recognised as an expense when incurred (eg research activities—the original and planned investigation undertaken with the prospect of gaining new scientific or technical knowledge and understanding.

Recognition of development cost (IAS 38)

An intangible asset arising from the development phase of an internal project must be recognised if, and only if, an entity can demonstrate all of the following:

a. the technical feasibility of completing the intangible asset so that it will be available for use or sale.

b. its intention to complete the intangible asset and use or sell it.

c. its ability to use or sell the intangible asset.

d. how the intangible asset will generate probable future economic benefits. Among other things, the entity can demonstrate the existence of a market for the output of the intangible asset or the intangible asset itself or, if it is to be used internally, the usefulness of the intangible asset.

e. the availability of adequate technical, financial and other resources to complete the development and to use or sell the intangible asset.

f. its ability to measure reliably the expenditure attributable to the intangible asset during its development.

Recognition, examples

- Recognise the asset?
  - a hospital’s backup backup generator (expect never to use it)
  - an oil explorer’s exploration rig
  - advertising expenditure
  - research and development expenditure
  - internally generated brand
  - lessee—short-term car rental agreement
  - firm order to acquire gold, cannot settle net
  - firm order to acquire gold, must settle net

Unit of account

- The concept—unit of account is the level at which an asset is aggregated or disaggregated for recognition purposes.
- Most IFRS do not prescribe the unit of account therefore judgement is required in applying recognition criteria to an entity's specific circumstances.

Example: ‘unit of account’ for PPE

- Entity acquires egg box manufacturing plant including the following PPE (fair value shown):
  – factory building (structure CU800,000 + roof CU200,000)
  – shredding machine CU2,000,000 and pulping machine CU6,000,000
  – 5 independently operating forklifts CU80,000 (individually CU15,000 to CU25,000)
  – 1,000+ reusable moulds (individually CU1 to CU100)

Account for how many separate items of PPE?

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Measurement

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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’

- Measurement part of *Conceptual Framework* is weak
- 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.

Cost-based measures used for assets?

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Historical cost ‘concept’

- Assets are recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.
- Liabilities are recorded at the amount of proceeds received in exchange for the obligation, or in some circumstances (for example, income taxes), at the amounts of cash or cash equivalents expected to be paid to satisfy the liability in the normal course of business.

Cost-based IFRS measures

- 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 measures are more common
  - unimpaired depreciated historic cost (IAS 16)
  - unimpaired amortised historical cost (IAS 38)
  - amortised cost (IFRS 9)

Impairment changes to a fair value or other measure

ASSET TYPE	MEASUREMENT AT INITIAL RECOGNITION	COST MODEL	BASIS OF IMPAIRMENT TEST
IAS 2 *Inventory*	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 *Property, Plant and Equipment*	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 *Intangibles Assets*	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 amortisation, if any	
IAS 40 *Investment Property*	Cost including transaction costs	Accounting policy choice: cost less accumulated depreciation (unless land) and impairment (if any)	
IFRS 9 *Financial Instruments*	Fair value	For particular business models amortised cost	IAS 39 specifies impairment rules

Judgements and estimates

- Cost of some items includes significant estimates
  - what is cost?
  - costs allocations
  - cost of dismantling, removal, restoration
  - costs of self constructed assets
- Depreciation represents the consumption of the assets service potential in the period. Measuring requires:
  - identifying significant components to be depreciated separately
  - estimating useful life and residual value
  - identifying the depreciation method that reflects most closely the consumption of the service potential of the item of PPE
- Determining the classes of assets (eg PPE)

Example: measurement of PPE after recognition

- Ex *Depreciation of commercial spacecraft*
  - Entity acquires spacecraft with the capacity to make 150 voyages to outer-space
  - legal restrictions limit the craft to a maximum of only 100 voyages before mandatory decommissioning—all voyages must be made within 5 years from the date of acquisition
  - management forecast that the spacecraft will make 5 voyages in year 1 (Y1); 15 in Y2; 30 in Y3; and 50 in Y4
  - management expect income per passenger to decline significantly each year as the 'novelty factor' of recreational space travel fades

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Example: continued

- Ex *Depreciation of commercial spacecraft* continued
  - although the entity could sell the spacecraft at the end of its useful life for a significant amount, the entity intends to destroy the item to prevent its competitors from accessing particular technologies
  - after two years the craft must be inspected by space travel authorities and certified for another two years (irrespective of the number of flights)

  Questions:

  1. *any separate components for depreciation?*
  2. *which depreciation method?*
  3. *is the spacecraft's residual value nil?*
  4. *what is the useful life of the spacecraft?*

Assets measured at fair value

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IFRS 13 *Fair Value Measurement* Definition

- 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*).
- 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.

ASSET TYPE	MEASUREMENT AT INITIAL RECOGNITION	MODEL BASED ON FAIR VALUE	BASIS OF IMPAIRMENT TEST
IFRS 9 *Financial Instruments*	**Fair value**	For specified financial assets and for particular business models: **fair value**	
IAS 16 *Property, Plant and Equipment*	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 *Intangible Assets*	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 *Investment Property*	Cost including transaction costs	Accounting policy choice: **fair value**	
IAS 41 *Agriculture*	**Fair value** less costs to sell	**Fair value** less costs to sell	

IAS 40 *Investment Property* subsequent measurement

- For subsequent measurement an entity must adopt either the fair value model or the cost model for all investment property
- All entities must estimate the fair value of investment property, either for measurement (if the entity uses the fair value model) or for disclosure (if it uses the cost model)
  - highly unlikely that an entity can change from fair value model to cost model because the change would not satisfy the IAS 8 criteria (more relevant information) for a voluntary change in accounting policy

IAS 41 *Agriculture*
Why fair value measurement?

- The value accretion of agricultural assets is unique
- Fair value measurement provides relevant, reliable, comparable and understandable measurement of future economic benefits
  - consider a plantation forest with a 30 year harvesting cycle: fair value measurement reflects the biological growth using current fair values
- Historical cost cannot accurately portray the value of an accreting asset
  - consider the plantation forest: no income would be reported until harvest and sale (30 years)
  - what is the cost of a fifth generation calf?

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 (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.

Judgements and estimates continued

- A PwC study of standing timber valuation practices observed that when applying DCF-models management made several important assumptions including:
  - expected income at harvest—variables included growth rate and price per unit of volume
  - expected costs during growth—including silvicultural costs, eg maintenance and thinning
  - expected point-of-sale-cost—including harvesting and transport to market
  - determining the appropriate discount rate.

When does IFRS 13 not apply?

Excluded from the scope	• IFRS 2 and IAS 17
Disclosures in IFRS 13 not required for	• Plan assets (IAS 19) • Retirement benefit plan investments (IAS 26) • Assets for which recoverable amount is fair value less cost of disposal (IAS 36)
Not required for measurements similar to fair value	• IAS 2 (net realisable value) • IAS 36 (value in use)

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IFRS 13
Fair Value Measurement

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Application guidance

- When measuring fair value use assumptions that market participants would use when pricing the asset or liability under current market conditions, including assumptions about risk.
- Characteristics of a particular asset or liability that a market participant would take into account when pricing the item at the measurment date, include:
  – age, condition and location of the asset
  – restrictions on the sale or use.

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Transaction and price

- Measured using the price in the principal market for the asset or liability (ie the market with the greatest volume and level of activity for the asset or liability) or, in the absence of a principal market, the most advantageous market for the asset or liability.

Non-financial assets

- Must reflect the use of a non-financial asset by market participants that maximises the value of the asset
  - physically possible
  - legally permissible
  - financially feasible
- Highest and best use is usually (but not always) the current use.

The fair value hierarchy

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Is there a quoted price in an active market for an identical asset or liability?
(Level 1 input)

Yes

Use the Level 1 input =
Level 1 measurement

Must use without adjustment

No

Are there any observable inputs* other than quoted prices for an identical asset or liability?

Yes

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

No

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

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

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

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Disclosure

- Information about an entity's valuation processes is required for fair value measurements categorised within Level 3 of the fair value hierarchy.
- A narrative discussion is required about the sensitivity of a fair value measurement categorised within Level 3.
- Quantitative sensitivity analysis is required for financial instruments measured at fair value.

Judgements and estimates

- An entity must take all information that is reasonably available to search for a principal market.
- determining fair value and the highest and best-use.for a non-financial asset.
- Assumptions that a market participant would use (including assumptions about risk).
- Determining the correct valuation technique to use and the inputs to the techniques, particularly on the income approach, require a wide range of estimates as:
  - discount rates
  - future cash flows
  - risks and uncertainty

Judgements and estimates continued

- The inputs used in the valuation techniques should primarily be based on observable inputs (where possible) to minimise the use of unobservable inputs.

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Derecognition

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Derecognition

- 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

Derecognition of PPE

- IAS 16.67 specifies: the carrying amount of an item of PPE shall be derecognised:
  - (a) on disposal; or
  - (b) when no future economic benefits are expected from its use or disposal.
- Note: derecognition of PPE does not necessarily occur when the asset no longer satisfies the conditions specified for its initial recognition. In particular, derecognition of PPE does not necessarily coincide with the loss of control of the asset.

Questions or comments?

**Expressions of individual views
by members of the IASB and its staff are encouraged. The views expressed in this presentation
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