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*Note: The section number (e.g. A) refers to the Strategic Business Reporting syllabus published by ACCA*

## Introduction

There are different study materials and modes for you to prepare for ACCA professional exams.

You can prepare the exam through self-study mode by reading textbooks and practicing revision tests from Approved Content Providers

Or you can go directly to the classes offered by ACCA Approved Learning Partners and stick into their notes.

However, no matter you are choosing which modes of study or which textbook, you need to know the technical articles published by ACCA for each paper is one of the best materials to prepare for your exams that you cannot miss.

In general, the articles are published by ACCA exam team and the contents are updated on a regular basis.

They highlight the core concepts or important areas that a lot of students cannot do well in the past exams.

The most important part is technical articles are generally the guidance to which question to be seen in upcoming exam.

Here are June 2018 examiners comments on ACCA Paper P7 (Advanced Audit & Assurance):

### Question Five

This was a reporting question and was in two sections. It was noted that this question was favoured by candidates who had obviously read the recently updated relevant article on the student website.

The second requirement was to critically appraise an extract from an auditor's report, which had been incorrectly prepared and needed amendment. As noted above it was clear that the candidates who selected this question had evidently read the relevant article and were able to identify that the sections were in the wrong order, contained inappropriate wording and that the key audit matters and emphasis of matters paragraphs had been incorrectly used. Good candidates were able to explain when an issue should be included as a key audit matter or if the issue would result in a qualification and hence needed to be part of the basis of opinion paragraph. Other candidates correctly commented that it would be inappropriate to include an emphasis of matter paragraph but that the report should include a section headed material uncertainty related to going concern.

Since it help thousands of students to prepare exam, I organized the articles published by ACCA and summarized them according to their topics and syllabus with relevant questions as Supplementary Notes for those who are interested to focus on the key or challenging areas.

Remember these articles are helping you to enhance your knowledge on particular subjects, and not a substitute of approved textbook.

## **Chapter 1    Accounting ethics in the digital age**

### Executive Summary

This article looks at a variety of ethical threats that a contemporary accountant working in the digital age may encounter and considers how these threats might be addressed.

It is widely accepted that accountants require more than merely professional competence because their actions contribute to the moral and ethical culture of organisations. This is increasingly true in recent times as accountants are faced with new digital technologies which may impact on the ethical considerations required.

Ethical dilemmas are not easily resolved as they often involve different perspectives and choices. Often there are different ethical and moral considerations which may include the environment, wealth distribution and personal relationships. Consequently, accountants frequently face a range of ethical dilemmas and recognising and dealing with these dilemmas is a significant part of being a professional accountant. Some of these issues can be resolved if accountants regularly engage with others as this engagement is likely to improve the accountant's ethical thinking by helping to view an issue from different perspectives. The ultimate decisions and actions an accountant might take can be affected by culture and social norms.

Strong ethical principles and behaviour are increasingly important in the digital age as there is potential for an increased range of threats. The threats to ethical behaviour can be categorised as follows:

- Self-interest threat: a financial or other interest (personal/organisational) will inappropriately influence a professional accountant's judgement or behaviour.
- Familiarity threat: owing to an established or close relationship with a client or employer, a professional accountant will be too sympathetic to that party's interests or too accepting of their work.
- Intimidation threat: a professional accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the professional accountant.
- Self-review: a professional accountant will not evaluate appropriately the results of a previous judgement, made earlier in the course of providing a current service.
- Advocacy: a professional accountant will promote a client's or employer's position to the point that the professional accountant's objectivity is compromised.

A contemporary accountant needs to be aware of these issues to allow him/her to deal with new digital scenarios. These will include cybersecurity, platform-based business models, big data and analytics, cryptocurrencies, distributed ledgers and artificial intelligence (AI). Ethical behaviour helps to build trust. Stakeholders are much more likely to continue investing their trust in the accountant if there is belief that the accountant will always act ethically.

The ethical principles which are most likely to be compromised by digital developments are professional competence and due care. Ethical challenges are likely to arise as the digital age can present new problems that have not been seen before. The accountant needs to understand the situation in depth and its context before being able to act. A lack of knowledge and expertise will create the risk of compromising professional competence and due care. It is difficult to apply ethical judgement on the use of digital technology without an understanding of what it is, and the opportunities and challenges it poses. To behave ethically and instil trust, professional accountants will need to learn new information relatively quickly, and to apply their judgement to this information, often in situations they may not have seen before. In addition to being directly connected to ethical situations that are personally experienced, it is possible to be indirectly connected to ethical situations by being an observer. In these situations, the ethical responsibility of the accountant is not diminished in any way.

Data theft is the most immediate and common impact of a breach in cybersecurity. Organisations hold a lot of valuable data in a variety of systems. The data itself could be internal (eg employee-related) or external (eg customer-related). The effects of data theft include financial loss and reputation/brand damage. Hackers can expose the vulnerability in an insecure database where commercial implementations have not been adequately secured.

IT security is a technology issue but the accountant is a custodian of sensitive data and needs to be aware of the risks. The risk that objectivity may be compromised arises from intimidation from a hacker's threats that data will be misused or destroyed. Additionally, the ethical duty of confidentiality, which would relate to customer or employee data, will also be compromised. Professional accountants need to know where there is information of value to external parties and should ensure that there are controls to secure it.

Regulation on data collection and analytics is increasing and organisations need to ensure the involvement of all relevant stakeholders. The accountant has a responsibility to ensure that regulations are understood, and properly addressed. The accountant could be accused of failure to act with integrity, competence and due care if customers' data is misused. The organisation should be honest in the way it has obtained consent from customers for using their data and should not compromise customers' confidentiality.

The accountant needs heightened ethical awareness when it comes to considering what action to take when there has been a breach of security in either their own organisation, or in one that they are advising. Given the accountant's obligation to act in the public interest,

it might be necessary to make a public disclosure, such as informing customers that their personal information has been exposed.

Platform-based businesses create value by bringing together consumers and producers. Examples are Airbnb, Uber, Google, Facebook, YouTube, eBay, and Alibaba. They have minimum levels of physical assets or inventory of their own to sell and do not need necessarily an increase in employee numbers to expand. They simply need to build up a substantial user base and connect them to a list of trusted specialist suppliers to provide the services. The individuals whose services these businesses offer may be contracted to work for the business (but are not employees) and this can often raise questions about employee protection and governance issues. The accountant may need to evaluate whether the supplier is being unfairly treated by the business, for example whether they are indeed employees and have specific rights or whether they are suppliers without such legal rights. Preventing unfair treatment of stakeholders is an issue for the accountant. In this scenario, there is a need to balance the commercial interests of the business with the interests of the suppliers and customers.

Distributed ledger technology (DLT) is a digital system for recording asset transactions in which the transactions and their details are recorded in multiple places at the same time. It is a digital database of records with information relevant to a group of participants. Unlike traditional databases, distributed ledgers have no central data store or administration functionality. All participants are looking at a common, shared, view of the records which are updated at the same time for all participants.

For example, in the UK, the Land Registry expects to use DLT to revolutionise the land registration and property buy-sell process. The reliability of such a system is paramount as is the need to ensure that sensitive citizen data is not at risk. Such a system will affect a significant proportion of the population and could result in significant economic consequences if it went wrong. In turn, this may present ethical challenges to the government's accountants and auditors. Accountants will therefore require a knowledge of distributed ledgers and be able to assess the risk of hacking or other unauthorised access to data. Professional accountants must be honest about whether they are comfortable with their knowledge of DLT and may need to consider the public interest when they are dealing with large volumes of sensitive information.

The increasing use of big data, and AI can enable quicker more consistent, evidence-based and accurate decisions. AI should be lawful, ethical and robust.

However, the characteristics of AI create questions around the ethical use of the new technologies. Artificial intelligence and machine learning technologies are rapidly transforming society and will almost certainly continue to do so in the coming decades. This social transformation will have deep ethical impacts, with these powerful new technologies both improving and disrupting human lives.

The accountant should review the governance and assurance needed around AI, so that all stakeholders can have confidence in its appropriate use. The following ethical issues may arise for the accountant:

- Artificial intelligence, like human intelligence, may be used maliciously.
- There are risks of bias in the system in unexpected and potentially detrimental ways.
- AI will be a threat to certain categories of employment.
- There is the question of technical safety and failure.

The principles embodied in ethical codes will remain highly relevant in the face of big data, and AI. However, while the ethical principles do not necessarily need to change, compliance is likely to become more difficult. A challenge is the lack of understanding around the contractual terms regarding the use of data.

Finally, the list of contexts in which confidentiality can be breached is ever growing, which makes it unique amongst the fundamental principles. However, the fundamental ethical principles are still fit for purpose. AI may well remove certain ethical threats for example, intimidation threat, but it may also complicate demonstration of compliance with the principles.

There are various ways of addressing an ethical issue and one such way is outlined below:

- The accountant must determine the nature of the decision that has to be made by determining the context of the ethical dilemma.
- The accountant must determine whose rights and interests are affected by the decision.
- The accountant must determine the rules of professional practice, internal and external governance codes and relevant laws.
- The accountant needs to set out the arguments in for and against taking a particular course of action.
- The accountant needs to formulate a solution that does justice to the arguments for and against the action to be taken.

- The accountant needs to take into account any negative consequences of taking or not taking the action.

It can therefore be seen that, although the environment in which an accountant operates may change, in this case become more digitalised, the basic ethical considerations remain the same. However, there may be some additional things that the accountant may need to think about if s/he finds herself/himself in an ethical dilemma that is set in a digital context. These considerations are summarised above and SBR candidates should have an awareness of these whilst preparing themselves for their forthcoming SBR exam and professional career.

**Written by a member of the Strategic Business Reporting examining team**

**Chapter 2 Concepts of profit or loss and other comprehensive income**

## Executive Summary

This article explains the current rules and the conceptual debate as to where in the statement of comprehensive income, profits and losses should be recognised – ie when should they be recognised in profit or loss and when in the other comprehensive income. Further, it explores the debate as to whether it is appropriate to recognise profits or losses twice.

The performance of a company is reported in the statement of profit or loss and other comprehensive income. IAS® 1, *Presentation of Financial Statements*, defines profit or loss as 'the total of income less expenses, excluding the components of other comprehensive income'. Other comprehensive income (OCI) is defined as comprising 'items of income and expense (including reclassification adjustments) that are not recognised in profit or loss as required or permitted by other International Financial Reporting Standards (IFRS®). Total comprehensive income is defined as 'the change in equity during a period resulting from transactions and other events, other than those changes resulting from transactions with owners in their capacity as owners'.

It is a myth, and simply incorrect, to state that only realised gains are included in profit or loss (P/L) and that only unrealised gains and losses are included in the OCI. For example, gains on the revaluation of land and buildings accounted for in accordance with IAS 16, *Property Plant and Equipment* (IAS 16 PPE), are recognised in OCI and accumulate in equity in Other Components of Equity (OCE). On the other hand, gains on the revaluation of land and buildings accounted for in accordance with IAS 40, *Investment Properties*, are recognised in P/L and are part of the Retained Earnings (RE). Both such gains are unrealised. The same point could be made with regard to the gains and losses on the financial asset of equity investments. If such financial assets are designated in accordance with IFRS 9, *Financial Instruments* (IFRS 9), at inception as Fair Value Through Other Comprehensive Income (FVTOCI) then the gains and losses are recognised in OCI and accumulated in equity in OCE. Whereas if management decides not to make this election, then the investment will by default be designated and accounted for as Fair Value Through Profit or Loss (FVTP&L) and the gains and losses are recognised in P/L and become part of RE.

There is at present no overarching accounting theory that justifies or explains in which part of the statement gains and losses should be reported. The International Accounting Standards Board (the Board)'s Conceptual Framework for Financial Reporting® is silent on the matter. So rather than have a clear principles based approach what we currently have is a rules based approach to this issue. It is down to individual accounting standards to direct when gains and losses are to be reported in OCI. This is clearly an unsatisfactory approach. It is confusing for users.

In July 2013 the Board published a discussion paper on its Conceptual Framework for Financial Reporting. This addressed the issue of where to recognise gains and losses. It suggests that the P/L should provide the primary source of information about the return an

entity has made on its economic resources in a period. Accordingly the P/L should recognise the results of transactions, consumption and impairments of assets and fulfilment of liabilities in the period in which they occur. In addition the P/L would also recognise changes in the cost of assets and liabilities as well as any gains or losses resulting from their initial recognition. The role of the OCI would then be to support the P/L. Gains and losses would only be recognised in OCI if it made the P&L more relevant. In my view whilst this may be an improvement on the current absence of any guidance it does not provide the clarity and certainty users crave.

## Recycling (the reclassification from equity to P&L)

Now let us consider the issue of recycling. This is where gains or losses are reclassified from equity to P/L as a reclassification adjustment. In other words gains or losses are first recognised in the OCI and then in a later accounting period also recognised in the P/L. In this way the gain or loss is reported in the total comprehensive income of two accounting periods and in colloquial terms is said to be recycled as it is recognised twice. At present it is down to individual accounting standards to direct when gains and losses are to be reclassified from equity to P/L as a reclassification adjustment. So rather than have a clear principles based approach on recycling what we currently have is a rules based approach to this issue. This is clearly, again, an unsatisfactory approach but also as we shall see one addressed by the Board's July 2013 discussion paper on its Conceptual Framework for Financial Reporting

IAS 21, *The Effects of Changes in Foreign Exchange Rates* (IAS 21), is one example of a standard that **requires** gains and losses to be reclassified from equity to P/L as a reclassification adjustment. When a group has an overseas subsidiary a group exchange difference will arise on the re-translation of the subsidiary's goodwill and net assets. In accordance with IAS 21 such exchange differences are recognised in OCI and so accumulate in OCE. On the disposal of the subsidiary, IAS 21 requires that the net cumulative balance of group exchange differences be reclassified from equity to P&L as a reclassification adjustment – ie the balance of the group exchange differences in OCE is transferred to P/L to form part of the profit on disposal.

IAS 16 PPE is one example of a standard that **prohibits** gains and losses to be reclassified from equity to P/L as a reclassification adjustment. If we consider land that cost \$10m which is treated in accordance with IAS 16 PPE. If the land is subsequently revalued to \$12m, then the gain of \$2m is recognised in OCI and will be taken to OCE. When in a later period

the asset is sold for \$13m, IAS 16 PPE specifically requires that the profit on disposal recognised in the P/L is \$1m – ie the difference between the sale proceeds of \$13m and the carrying value of \$12m. The previously recognised gain of \$2m is not recycled/reclassified back to P/L as part of the gain on disposal. However the \$2m balance in the OCE reserve is now redundant as the asset has been sold and the profit is realised. Accordingly, there will be a transfer in the Statement of Changes in Equity, from the OCE of \$2m into RE.

## Double entry

For those who love the double entry let me show you the purchase, the revaluation, the disposal and the transfer to RE in this way.

### On purchase

\$m

\$m

Dr Land PPE

10

Cr Cash

10

### On revaluation

Dr Land PPE

2

Cr OCE and recognised in OCI

2

**On disposal**

Dr Cash

13

Cr Land PPE

12

Cr P/L

1

**On transfer**

Dr OCE

2

Cr Retained earnings

2

If IAS 16 PPE allowed the reclassification from equity to P&L as a reclassification adjustment, the profit on disposal recognised in P&L would be \$3m including the \$2m

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reclassified from equity to P&L and the last two double entries above replaced with the following.

On reclassification from equity to P/L		\$m	\$m
Dr	Cash	13	
Cr	Land PPE		12
Cr	P/L		3
Dr	OCE	2	

IFRS 9 also prohibits the recycling of the gains and losses on FVTOCI investments to P/L on disposal. The no reclassification rule in both IAS 16 PPE and IFRS 9 means that such gains on those assets are only ever reported once in the statement of profit or loss and other comprehensive income – ie are only included once in total comprehensive income. However many users, it appears, rather ignore the total comprehensive income and the OCI and just base their evaluation of a company's performance on the P/L. These users then find it strange that gains that have become realised from transactions in the accounting period are not fully reported in the P/L of the accounting period. As such we can

see the argument in favour of reclassification. With no reclassification the earnings per share will never fully include the gains on the sale of PPE and FVTOCI investments.

The following extract from the statement of comprehensive income summarises the current accounting treatment for which gains and losses are required to be included in OCI and, as required, discloses which gains and losses can and cannot be reclassified back to profit and loss.

**Extract from the statement of profit or loss and other comprehensive income**

	\$m
Profit for the year	XX
Other comprehensive income	
Gains and losses that cannot be reclassified back to profit or loss	
Changes in revaluation surplus where the revaluation method is used in accordance with IAS 16	XX / (XX)

Remeasurements of a net defined benefit liability or asset recognised in accordance with IAS 19	XX / (XX)
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Gains and losses on remeasuring FVTOCI financial assets in accordance with IFRS 9	XX / (XX)
---	-----------

Gains and losses that can be reclassified back to profit or loss

Group exchange differences from translating functional currencies into presentation currency in accordance with IAS 21	XX / (XX)
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The effective portion of gains and losses on hedging instruments in a cash flow hedge under IFRS 9	<u>XX / (XX)</u>
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Total comprehensive income	<u>XX / (XX)</u>
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## The future of reclassification

In the July 2013 discussion paper on the Conceptual Framework for Financial Reporting the role of the OCI and the reclassification from equity to P/L is debated.

## No OCI and no reclassification

It can be argued that reclassification should simply be prohibited. This would free the statement of profit or loss and other comprehensive income from the need to formally to classify gains and losses between P/L and OCI. This would reduce complexity and gains and losses could only ever be recognised once. There would still remain the issue of how to define the earnings in earnings per share, a ratio loved by investors, as clearly total comprehensive income would contain too many gains and losses that were non-operational, unrealised, outside the control of management and not relating to the accounting period.

## Narrow approach to the OCI

Another suggestion is that the OCI should be restricted, should adopt a narrow approach. On this basis only bridging and mismatch gains and losses should be included in OCI and be reclassified from equity to P/L.

A revaluation surplus on a financial asset classified as FVTOCI is a good example of a bridging gain. The asset is accounted for at fair value on the statement of financial position but effectively at cost in P/L. As such, by recognising the revaluation surplus in OCI, the OCI is acting as a bridge between the statement of financial position and the P/L. On disposal reclassification ensures that the amount recognised in P/L will be consistent with the amounts that would be recognised in P/L if the financial asset had been measured at amortised cost.

The effective gain or loss on a cash flow hedge of a future transaction is an example of a mismatch gain or loss as it relates to a transaction in a future accounting period so needs to be carried forward so that it can be matched in the P/L of a future accounting period. Only by recognising the effective gain or loss in OCI and allowing it to be reclassified from equity to P/L can users see the results of the hedging relationship.

## Broad approach to the OCI

A third proposition is for the OCI to adopt a broad approach, by also including transitory gains and losses. The Board would decide in each IFRS whether a transitory remeasurement should be subsequently recycled.

Examples of transitory gains and losses are those that arise on the remeasurement of defined benefit pension funds and revaluation surpluses on PPE.

## Conclusion

Whilst the Board has not yet determined which approach will be adopted, its chairman Hans Hoogervorst has gone on the record as saying 'It is absolutely vital that the P/L contains all information that can be relevant to investors and that nothing of importance gets left out... and... the Board should be very disciplined in its use of OCI as resorting to OCI too easily would undermine the credibility of net income so the OCI should only be used as an instrument of last resort'. Now that sounds like a personal endorsement of the narrow approach to me!

**Tom Clendon is a lecturer at FTMS based in Singapore and is the author of the second edition of *A Student's Guide to Group Accounts* (published by Kaplan Publishing)**

**Chapter 3 Profit, loss and other comprehensive income**

## Executive Summary

This article looks at what differentiates profit or loss from other comprehensive income and where items should be presented.

The purpose of the statement of profit or loss and other comprehensive income (OCI) is to show an entity's financial performance in a way that is useful to a wide range of users so that they may attempt to assess the future net cash inflows of an entity. The statement should be classified and aggregated in a manner that makes it understandable and comparable. International Financial Reporting Standards (IFRS®) currently require the statement to be presented as either one statement, being a combined statement of profit or loss and other comprehensive income or two statements, being the statement of profit or loss and the statement of profit or loss and other comprehensive income. An entity has to show separately in OCI, those items which would be reclassified (recycled) to profit or loss and those items which would never be reclassified (recycled) to profit or loss. The related tax effects have to be allocated to these sections.

Profit or loss includes all items of income or expense (including reclassification adjustments) except those items of income or expense that are recognised in OCI as required or permitted by IFRS standards. Reclassification adjustments are amounts recycled to profit or loss in the current period that were recognised in OCI in the current or previous periods. An example of items recognised in OCI that may be reclassified to profit or loss are foreign currency gains on the disposal of a foreign operation and realised gains or losses on cash flow hedges. Those items that may not be reclassified are changes in a revaluation surplus under IAS® 16, *Property, Plant and Equipment*, and actuarial gains and losses on a defined benefit plan under IAS 19, *Employee Benefits*.

However, there is a general lack of agreement about which items should be presented in profit or loss and in OCI. The interaction between profit or loss and OCI is unclear, especially the notion of reclassification and when or which OCI items should be reclassified. A common misunderstanding is that the distinction is based upon realised versus unrealised gains. This lack of a consistent basis for determining how items should be presented has led to an inconsistent use of OCI in IFRS standards. It may be difficult to deal with OCI on a conceptual level since the International Accounting Standards Board (the Board) are finding it difficult to find a sound conceptual basis. However, there is urgent need for some guidance around this issue.

Opinions vary but there is a feeling that OCI has become a 'dumping ground' for anything controversial because of a lack of clear definition of what should be included in the statement. Many users are thought to ignore OCI as the changes reported are not caused by the operating flows used for predictive purposes. Financial performance is not defined in the Conceptual Framework for Financial Reporting® but could be viewed as reflecting the

value the entity has generated in the period and this can be assessed from other elements of the financial statements and not just the statement of profit or loss and other comprehensive income. Examples would be the statement of cash flows and disclosures relating to operating segments. The presentation in profit or loss and OCI should allow a user to depict financial performance including the amount, timing and uncertainty of the entity's future net cash inflows and how efficiently and effectively the entity's management have discharged their duties regarding the resources of the entity.

## Reclassification: for and against

There are several arguments for and against reclassification. If reclassification ceased, then there would be no need to define profit or loss, or any other total or subtotal in profit or loss, and any presentation decisions can be left to specific IFRS standards. It is argued that reclassification protects the integrity of profit or loss and provides users with relevant information about a transaction that occurred in the period. Additionally, it can improve comparability where IFRS standards permit similar items to be recognised in either profit or loss or OCI.

Those against reclassification argue that the recycled amounts add to the complexity of financial reporting, may lead to earnings management and the reclassification adjustments may not meet the definitions of income or expense in the period as the change in the asset or liability may have occurred in a previous period.

The original logic for OCI was that it kept income-relevant items that possessed low reliability from contaminating the earnings number. Markets rely on profit or loss and it is widely used. The OCI figure is crucial because it can distort common valuation techniques used by investors, such as the price/earnings ratio. Thus, profit or loss needs to contain all information relevant to investors. Misuse of OCI would undermine the credibility of net income. The use of OCI as a temporary holding for cash flow hedging instruments and foreign currency translation is non-controversial.

However, other treatments such the policy of IFRS 9 to allow value changes in equity investments to go through OCI, are not accepted universally.

US GAAP will require value changes in all equity investments to go through profit or loss. Accounting for actuarial gains and losses on defined benefit schemes are presented through OCI and certain large US corporations have been hit hard with the losses incurred

on these schemes. The presentation of these items in OCI would have made no difference to the ultimate settled liability but if they had been presented in profit or loss, the problem may have been dealt with earlier. An assumption that an unrealised loss has little effect on the business is an incorrect one.

The Discussion Paper on the Conceptual Framework for Financial Reporting considers three approaches to profit or loss and reclassification. The first approach prohibits reclassification. The other approaches, the narrow and broad approaches, require or permit reclassification. The narrow approach allows recognition in OCI for bridging items or mismatched remeasurements. While the broad approach has an additional category of 'transitory measurements' (for example, remeasurement of a defined benefit obligation) which would allow the Board greater flexibility. The narrow approach significantly restricts the types of items that would be eligible to be presented in OCI and gives the Board little discretion when developing or amending IFRS standards.

A bridging item arises where the Board determines that the statement of comprehensive income would communicate more relevant information about financial performance if profit or loss reflected a different measurement basis from that reflected in the statement of financial position. For example, if a debt instrument is measured at fair value in the statement of financial position, but is recognised in profit or loss using amortised cost, then amounts previously reported in OCI should be reclassified into profit or loss on impairment or disposal of the debt instrument. The Board argues that this is consistent with the amounts that would be recognised in profit or loss if the debt instrument were to be measured at amortised cost.

A mismatched remeasurement arises where an item of income or expense represents an economic phenomenon so incompletely that, in the opinion of the Board, presenting that item in profit or loss would provide information that has little relevance in assessing the entity's financial performance. An example of this is when a derivative is used to hedge a forecast transaction; changes in the fair value of the derivative may arise before the income or expense resulting from the forecast transaction. The argument is that before the results of the derivative and the hedged item can be matched together, any gains or losses resulting from the remeasurement of the derivative, to the extent that the hedge is effective and qualifies for hedge accounting, should be reported in OCI. Subsequently, those gains or losses are reclassified into profit or loss when the forecast transaction affects profit or loss. This allows users to see the results of the hedging relationship.

The Board's preliminary view is that any requirement to present a profit or loss total or subtotal could also result in some items being reclassified. The commonly suggested attributes for differentiation between profit or loss and OCI (realised/unrealised, frequency of occurrence, operating/non-operating, measurement certainty/uncertainty, realisation in the short/long-term or outside management control) are difficult to distil into a set of principles.

Therefore, the Board is suggesting two broad principles, namely:

(a) Profit or loss provides the primary source of information about the return an entity has made on its economic resources in a period.

(b) To support profit or loss, OCI should only be used if it makes profit or loss more relevant.

The Board feels that changes in cost-based measures and gains or losses resulting from initial recognition should not be presented in OCI and that the results of transactions, consumption and impairments of assets and fulfilment of liabilities should be recognised in profit or loss in the period in which they occur. As a performance measure, profit or loss is more used although there are a number of other performance measures derived from the statement of profit or loss and OCI.

**Written by a member of the Strategic Business Reporting examining team**

## **Chapter 4 The Conceptual Framework**

### Executive Summary

In March 2018, the International Accounting Standards Board finished its revision of The Framework for Financial Reporting.

The primary purpose of financial information is to be useful to existing and potential investors, lenders and other creditors (users) when making decisions about the financing of the entity and exercising rights to vote on, or otherwise influence, management's actions that affect the use of the entity's economic resources. The Framework sets out the information needed to assess management's stewardship, and separates this from the information that users need to assess the prospects of the entity's future net cash flows.

## Chapter 1 – The objective of general-purpose financial reporting

The purpose of the Framework is to:

- assist the IASB to develop and revise its standards
- assist entities to develop consistent accounting policies when no standard applies to a particular transaction or other event, or when a standard allows a choice of accounting policy, and
- assist all stakeholders to understand and interpret the standards

IFRSs take precedence over the Framework. However, should new IFRSs depart from the Framework, the IASB will explain the reasons in the Basis for Conclusions on that standard.

When considering the objective of general-purpose financial reporting, the Board reintroduced the concept of 'stewardship'. This is a relatively minor change and, as many of the respondents to the Discussion Paper highlighted, stewardship is not a new concept. The importance of stewardship by management is inherent within the existing Framework and within financial reporting, so this statement largely reinforces what already exists.

Users base their expectations of returns on their assessment of:

- the amount, timing and uncertainty of future net cash inflows to the entity, and
- management's stewardship of the entity's resources.

## Chapter 2 – Qualitative characteristics of useful financial information

The Framework sets out the qualitative characteristics of useful financial information. However, these characteristics are subject to cost constraints, and it is therefore important to determine whether the benefits to users of the information justify the cost incurred by the entity providing it. The Framework clarifies what makes financial information useful, that is,

information must be relevant and must faithfully represent the substance of financial information.

Relevance and faithful representation remain as the two fundamental qualitative characteristics. The four enhancing qualitative characteristics continue to be timeliness, understandability, verifiability and comparability.

Whilst the qualitative characteristics remain unchanged, the Board decided to reinstate explicit references to prudence and substance over form.

Prudence is introduced in support of the principle of neutrality for the purposes of faithful representation. Prudence is understood here as the exercise of caution when making judgements under conditions of uncertainty. Users find this concept important as they feel that it should help counteract the natural optimistic bias of management. By acknowledging neutrality and prudence, the Framework includes all conceptual underpinnings for the development of IFRSs.

The Board concluded that substance over form was not a separate component of faithful representation. The Board also decided that, if financial statements represented a legal form that differed from the economic substance, then they could not result in a faithful representation.

Whilst that statement is true, the Board felt that the importance of the concept needed to be reinforced and so a statement has now been included in Chapter 2 that states that faithful representation provides information about the substance of an economic phenomenon rather than its legal form.

Many standards, such as International Accounting Standard (IAS®) 37 Provisions, Contingent Liabilities and Contingent Assets, apply a system of asymmetric prudence. In IAS 37, a probable outflow of economic benefits would be recognised as a provision, whereas a probable inflow would only be shown as a contingent asset and merely disclosed in the financial statements. Therefore, two sides in the same court case could have differing accounting treatments despite the likelihood of the pay-out being identical for either party. Many respondents highlighted this asymmetric prudence as necessary under some accounting standards and felt that a discussion of the term was required. Whilst this is true, the Board believes that the Framework should not identify asymmetric prudence as a necessary characteristic of useful financial reporting.

The Framework states that the concept of prudence does not imply a need for asymmetry, such as the need for more persuasive evidence to support the recognition of assets than liabilities. It has included a statement that, in financial reporting standards, such asymmetry may sometimes arise as a consequence of requiring the most useful information.

Many users would prefer the concept of measurement reliability, but the Framework provides clarification concerning measurement uncertainties which are defined in terms of faithful representation. Faithful representation of information does not mean that that information must be accurate in all respects. As the use of estimates are an essential part of the preparation of financial information and this does not necessarily weaken the usefulness of the information. The Framework strikes a balance between relevance and faithful representation in order to provide useful information to the users of financial statements. Information with a very high degree of uncertainty should be replaced by information whose estimation involves less uncertainty as long as explanations are provided. The IASB states that a faithful representation provides information about the substance of an economic phenomenon instead of merely providing information about its legal form.

## Chapter 3 – Financial statements and the reporting entity

This addition relates to the description and boundary of a reporting entity. The Board has proposed the description of a reporting entity as: an entity that chooses or is required to prepare general purpose financial statements.

It is useful to users to understand that the general purpose financial statements are prepared on the assumption that the reporting entity is a going concern. If this assumption is not appropriate, they are prepared in accordance with a basis other than IFRSs. The Framework explains that this assumption means that the entity has neither the intention nor the need to enter liquidation or cease trading in the foreseeable future. The Framework also states that the financial statements are prepared from the perspective of the reporting entity as a whole, not from the perspective of some or all of the entity's users. This is a useful clarification for users, because in practice the perspective taken in drafting the various standards is not always clear.

## Chapter 4 – The elements of financial statements

The Board has changed the definitions of assets and liabilities. The changes to the definitions of assets and liabilities can be seen below.

	<b>2010 definition</b>	<b>2018 definition</b>	<b>Supporting concept</b>
Asset (of an entity)	A resource controlled by the entity as a result of past events and from which future economic benefits are <b>expected</b> to flow to the entity.	A present economic resource controlled by the entity as a result of past events.	
Economic resource		A right that has the <b>potential to produce</b> economic benefits	
Liability (of an entity)	A present obligation of the entity arising from past events, the settlement of which is <b>expected</b> to result in an outflow from the entity of resources embodying economic benefits.	A present obligation of the entity to transfer an economic resource as a result of past events.	An entity's obligation to transfer and economic resource must have the <b>potential to require</b> the entity to transfer an economic resource to another party.

Obligation		A duty of responsibility that an entity has no practical ability to avoid.	
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The Board has therefore changed the definitions of assets and liabilities. Whilst the concept of 'control' remains for assets and 'present obligation' for liabilities, the key change is that the term 'expected' has been replaced. For assets, 'expected economic benefits' has been replaced with 'the potential to produce economic benefits'. For liabilities, the 'expected outflow of economic benefits' has been replaced with the 'potential to require the entity to transfer economic resources'.

The reason for this change is that some people interpret the term 'expected' to mean that an item can only be an asset or liability if some minimum threshold were exceeded. As no such interpretation has been applied by the Board in setting recent IFRS Standards, this definition has been altered in an attempt to bring clarity.

The Board has acknowledged that some IFRS Standards do include a probability criterion for recognising assets and liabilities. For example, IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* states that a provision can only be recorded if there is a probable outflow of economic benefits, while IAS 38 *Intangible Assets* highlights that for development costs to be recognised there must be a probability that economic benefits will arise from the development.

The proposed change to the definition of assets and liabilities **will leave these unaffected**. The Board has explained that these standards don't rely on an argument that items fail to meet the definition of an asset or liability. Instead, these standards include probable inflows or outflows as a criterion for **recognition**. The Board believes that **this uncertainty is best dealt with in the recognition or measurement of items**, rather than in the definition of assets or liabilities.

## Chapter 5 – Recognition and derecognition

The Board has confirmed a new approach to recognition, which requires decisions to be made by reference to the qualitative characteristics of financial information. The Board has

confirmed that an entity should recognise an asset or a liability (and any related income, expense or changes in equity) if such recognition provides users of financial statements with:

- relevant information about the asset or the liability and about any income, expense or changes in equity
- a faithful representation of the asset or liability and of any income, expenses or changes in equity, and
- information that results in benefits exceeding the cost of providing that information.

A key change to this is the removal of a 'probability criterion'. This has been removed as different financial reporting standards apply different criterion; for example, some apply probable, some virtually certain and some reasonably possible. This also means that it will not specifically prohibit the recognition of assets or liabilities with a low probability of an inflow or outflow of economic resources.

This is potentially controversial, and the Framework addresses this specifically as chapter 5; paragraph 15 states that 'an asset or liability can exist even if the probability of an inflow or outflow of economic benefits is low'.

The key point here relates to relevance. If the probability of the event is low, this may not be the most relevant information. The most relevant information may be about the potential magnitude of the item, the possible timing and the factors affecting the probability.

Even stating all of this, the Framework acknowledges that the most likely location for items such as this is to be included within the notes to the financial statements.

Finally, a major change in chapter 5 relates to derecognition. This is an area not previously addressed by the Framework but the Framework states that derecognition should aim to represent faithfully both:

(a) the assets and liabilities retained after the transaction or other event that led to the derecognition (including any asset or liability acquired, incurred or created as part of the transaction or other event), and

(b) the change in the entity's assets and liabilities as a result of that transaction or other event.

## Chapter 6 – Measurement

The selection of a measurement basis must take into account the key characteristics of useful financial information (relevance and faithful representation) and more particularly the characteristics of the element, the contribution to cash flows due to economic activities, and measurement uncertainty and the cost constraint.

A balance is needed between giving entities the flexibility to provide relevant information that faithfully represents the entity's assets, liabilities, equity, income and expenses; and requiring information that is comparable, both from period to period and across entities.

Effective communication in financial statements is also supported by considering that entity-specific information is more useful than standardised descriptions and duplication of information in different parts of the financial statements is usually unnecessary and can make financial statements less understandable.

The first of the measurement bases discussed is historical cost. The accounting treatment of this is unchanged, but the Framework now explains that the carrying amount of non-financial items held at historical cost should be adjusted over time to reflect the usage (in the form of depreciation or amortisation). Alternatively, the carrying amount can be adjusted to reflect that the historical cost is no longer recoverable (impairment). Financial items held at historical cost should reflect subsequent changes such as interest and payments, following the principle often referred to as amortised cost.

The Framework also describes three measurements of current value: fair value, value in use (or fulfilment value for liabilities) and current cost.

Fair value continues to be defined as the price in an orderly transaction between market participants. Value in use (or fulfilment value) is defined as an entity-specific value, and remains as the present value of the cash flows that an entity expects to derive from the continuing use of an asset and its ultimate disposal.

Current cost is different from fair value and value in use, as current cost is an entry value. This looks at the value in which the entity would acquire the asset (or incur the liability) at current market prices, whereas fair value and value in use are exit values, focusing on the values which will be gained from the item.

Relevance is a key issue. The Framework says that historical cost may not provide relevant information about assets held for a long period of time, and are certainly unlikely to provide relevant information about derivatives. In both cases, it is likely that some variation of current value will be used to provide more predictive information to users.

Conversely, the Framework suggests that fair value may not be relevant if items are held solely for use or to collect contractual cash flows. Alongside this, the Framework specifically mentions items used in a combination to generate cash flows by producing goods or services to customers. As these items are unlikely to be able to be sold separately without penalising the activities, a cost-based measure is likely to provide more relevant information, as the cost is compared to the margin made on sales.

## Chapter 7 – Presentation and disclosure

This is a new section, containing the principles relating to how items should be presented and disclosed.

The first of these principles is that income and expenses should be included in the statement of profit or loss unless relevance or faithful representation would be enhanced by including a change in the current value of an asset or a liability in OCI.

The second of these relates to the recycling of items in OCI into profit or loss. IAS 1 *Presentation of Financial Statements* suggests that these should be disclosed as items to be reclassified into profit or loss, or not reclassified.

The recycling of OCI is contentious and some commenters argue that all OCI items should be recycled. Others argue that OCI items should never be recycled, whilst some argue that only some items should be recycled.

The Framework contains a statement that income and expenses included in OCI are recycled when doing so would enhance the relevance or faithful representation of the information. OCI may not be recycled if there is no clear basis for identifying the period in which recycling should occur.

**Written by a member of the *Strategic Business Reporting* examining team**

## **Chapter 5   Deferred tax**

### Executive Summary

This article considers the aspects of deferred tax that are relevant to the Financial Reporting exam before moving on to the more complicated situations that may be tested in the Strategic Business Reporting exam.

**Deferred tax is a topic that is consistently tested in Financial Reporting (FR) and is often tested in further detail in Strategic Business Reporting (SBR). This article will start by considering aspects of deferred tax that are relevant to FR before moving on to the more complicated situations that may be tested in SBR.**

## The basics

Deferred tax is accounted for in accordance with IAS® 12, *Income Taxes*. In FR, deferred tax normally results in a liability being recognised within the Statement of Financial Position. IAS 12 defines a deferred tax liability as being the amount of income tax payable in future periods in respect of taxable temporary differences. So, in simple terms, deferred tax is tax that is payable in the future. However, to understand this definition more fully, it is necessary to explain the term 'taxable temporary differences'.

Temporary differences are defined as being differences between the carrying amount of an asset (or liability) within the Statement of Financial Position and its tax base ie the amount at which the asset (or liability) is valued for tax purposes by the relevant tax authority.

Taxable temporary differences are those on which tax will be charged in the future when the asset (or liability) is recovered (or settled).

IAS 12 requires that a deferred tax liability is recorded in respect of all taxable temporary differences that exist at the year-end – this is sometimes known as the full provision method.

All of this terminology can be rather overwhelming and difficult to understand, so consider it alongside an example. Depreciable non-current assets are the typical deferred tax example used in FR.

Within financial statements, non-current assets with a limited useful life are subject to depreciation. However, within tax computations, non-current assets are subject to capital allowances (also known as tax depreciation) at rates set within the relevant tax legislation. Where at the year-end the cumulative depreciation charged and the cumulative capital allowances claimed are different, the carrying amount of the asset (cost less accumulated depreciation) will then be different to its tax base (cost less accumulated capital allowances) and hence a taxable temporary difference arises.

**EXAMPLE 1**

A non-current asset costing \$2,000 was acquired at the start of year 1. It is being depreciated straight line over four years, resulting in annual depreciation charges of \$500. Thus a total of \$2,000 of depreciation is being charged. The capital allowances granted on this asset are:



Year 1	800
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Year 2	600
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Year 3	360
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Year 4	<u>240</u>
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Total capital allowances	<u>2,000</u>
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**Table 1** shows the carrying amount of the asset, the tax base of the asset and therefore the temporary difference at the end of each year.

As stated above, deferred tax liabilities arise on taxable temporary differences, ie those temporary differences that result in tax being payable in the future as the temporary

difference reverses. So, how does the above example result in tax being payable in the future?

Entities pay income tax on their taxable profits. When determining taxable profits, the tax authorities start by taking the profit before tax (accounting profits) of an entity from their financial statements and then make various adjustments. For example, depreciation is considered a disallowable expense for taxation purposes but instead tax relief on capital expenditure is granted in the form of capital allowances. Therefore, taxable profits are arrived at by adding back depreciation and deducting capital allowances from the accounting profits. Entities are then charged tax at the appropriate tax rate on these taxable profits.

TABLE 1: THE CARRYING VALUE, THE TAX BASE OF THE ASSET AND THEREFORE THE TEMPORARY DIFFERENCE AT THE END OF EACH YEAR (EXAMPLE 1)

Year	Carrying value (Cost - accumulated depreciation)	Tax base (Cost - accumulated capital allowances)	Temporary difference
	\$	\$	\$
1	1,500	1,200	300
2	1,000	600	400
3	500	240	260
4	Nil	Nil	Nil

In the above example, when the capital allowances are greater than the depreciation expense in years 1 and 2, the entity has received tax relief early. This is good for cash flow in that it delays (ie defers) the payment of tax. However, the difference is only a temporary difference and so the tax will have to be paid in the future. In years 3 and 4, when the capital allowances for the year are less than the depreciation charged, the entity is being charged additional tax and the temporary difference is reversing. Hence the temporary differences can be said to be taxable temporary differences.

Notice that overall, the accumulated depreciation and accumulated capital allowances both equal \$2,000 – the cost of the asset – so over the four-year period, there is no difference between the taxable profits and the profits per the financial statements.

At the end of year 1, the entity has a temporary difference of \$300, which will result in tax being payable in the future (in years 3 and 4). In accordance with the concept of prudence, a liability is therefore recorded equal to the expected tax payable.

Assuming that the tax rate applicable to the company is 25%, the deferred tax liability that will be recognised at the end of year 1 is  $25\% \times \$300 = \$75$ . This will be recorded by crediting (increasing) a deferred tax liability in the Statement of Financial Position and

debiting (increasing) the tax expense in the Statement of Profit or Loss.

By the end of year 2, the entity has a taxable temporary difference of \$400, ie the \$300 bought forward from year 1, plus the additional difference of \$100 arising in year 2. A liability is therefore now recorded equal to  $25\% \times \$400 = \$100$ . Since there was a liability of \$75 recorded at the end of year 1, the double entry that is recorded in year 2 is to credit (increase) the liability and debit (increase) the tax expense by \$25.

At the end of year 3, the entity's taxable temporary differences have decreased to \$260 (since the company has now been charged tax on the difference of \$140). Therefore in the future, the tax payable will be  $25\% \times \$260 = \$65$ . The deferred tax liability now needs reducing from \$100 to \$65 and so is debited (a decrease) by \$35. Consequently, there is now a credit (a decrease) to the tax expense of \$35.

At the end of year 4, there are no taxable temporary differences since now the carrying amount of the asset is equal to its tax base. Therefore the opening liability of \$65 needs to be removed by a debit entry (a decrease) and hence there is a credit entry (a decrease) of \$65 to the tax expense. This can all be summarised in the following working.

*The movements in the liability are recorded in the Statement of Profit or Loss as part of the taxation charge*

Year	1	2	3	4
	\$	\$	\$	\$
Opening deferred tax liability	0	75	100	65
Increase/(decrease) in the year	<u>75</u>	<u>25</u>	<u>(35)</u>	<u>(65)</u>

Year	1	2	3	4
	\$	\$	\$	\$

Closing deferred tax liability	<u>75</u>	<u>100</u>	<u>65</u>	<u>0</u>
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The closing figures are reported in the **Statement of Financial Position** as part of the deferred tax liability.

### Proforma

Example 1 provides a proforma, which may be a useful format to deal with deferred tax within a published financial statements question. The movement in the deferred tax liability in the year is recorded in the Statement of Profit or Loss where:

- an increase in the liability, increases the tax expense
- a decrease in the liability, decreases the tax expense.

The closing figures are reported in the Statement of Financial Position as the deferred tax liability.

### The Statement of Profit or Loss

As IAS 12 considers deferred tax from the perspective of temporary differences between the carrying amount and tax base of assets and liabilities, the standard can be said to take a 'balance sheet approach'. However, it will be helpful to consider the effect on the Statement of Profit or Loss.

Continuing with the previous example, suppose that the profit before tax of the entity for each of years 1 to 4 is \$10,000 (after charging depreciation). Since the tax rate is 25%, it would then be logical to expect the tax expense for each year to be \$2,500. However, income tax is based on taxable profits not on the accounting profits.

The taxable profits and so the actual tax liability for each year could be calculated as in Table 2.

The income tax liability is then recorded as a tax expense. As we have seen in the example, accounting for deferred tax then results in a further increase or decrease in the tax expense. Therefore, the final tax expense for each year reported in the Statement of Profit or Loss would be as in Table 3.

It can therefore be said that accounting for deferred tax is ensuring that the matching principle is applied. The tax expense reported in each period is the tax consequences (ie tax charges less tax relief) of the items reported within profit in that period.

## EXAMPLE 1 PROFORMA

Opening deferred tax liability	\$ X	As given in the trial balance
Increase/(decrease) in the year <i>Tax rate % x Increase / Decrease in year-end taxable temporary differences</i>	X/(X)	This is taken to the taxation charge in the Income Statement
Closing deferred tax liability <i>Tax rate % x Year-end taxable temporary differences</i>	X	This is reported in the Statement of Financial Position

TABLE 2: TAXABLE PROFIT AND ACTUAL TAX LIABILITY CALCULATION (EXAMPLE 1)

	Year 1	Year 2	Year 3	Year 4
	\$	\$	\$	\$
Profit before tax	10,000	10,000	10,000	10,000
Depreciation	500	500	500	500
Capital allowances	(800)	(600)	(360)	(240)
Taxable profits	<u>9,700</u>	<u>9,900</u>	<u>10,140</u>	<u>10,260</u>
Tax liability @ 25% of taxable profits	<u>2,425</u>	<u>2,475</u>	<u>2,535</u>	<u>2,565</u>

TABLE 3: FINAL TAX EXPENSE FOR EACH REPORTED INCOME STATEMENT YEAR (EXAMPLE 1)

	Year 1	Year 2	Year 3	Year 4
Income tax	2,425	2,475	2,535	2,565
Increase/(decrease) due to deferred tax	75	25	(35)	(65)
Total tax expense	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>	<u>2,500</u>

## The FR exam

Deferred tax is consistently tested in the published financial statements financial statements question in the FR exam. Here are some hints on how to deal with the information in the question.

- The deferred tax liability given within the trial balance or draft financial statements will be the opening liability balance.

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- In the notes to the question there will be information to enable you to calculate the closing liability for the SFP or the increase/decrease in the liability.

It is important that you read the information carefully. You will need to ascertain exactly what you are being told within the notes to the question and therefore how this relates to the working that you can use to calculate the figures for the answer.

Consider the following sets of information – all of which will achieve the same ultimate answer in the published financial statements.

**EXAMPLE 2**

The trial balance shows a credit balance of \$1,500 in respect of a deferred tax liability.

The notes to the question could contain one of the following sets of information:

1. At the year-end, the required deferred tax liability is \$2,500.
2. At the year-end, it was determined that an increase in the deferred tax liability of \$1,000 was required.
3. At the year-end, there are taxable temporary differences of \$10,000. Tax is charged at a rate of 25%.
4. During the year, taxable temporary differences increased by \$4,000. Tax is charged at a rate of 25%.

TABLE 4: EXAMPLE 2 – PUBLISHED ACCOUNTS QUESTION

<b>Situation 1</b>		
Opening deferred tax liability	\$ 1,500	<i>Provided in trial balance</i>
Increase in the year to be taken to IS as an increase in tax expense	1,000	<i>Balancing figure</i>
Closing deferred tax liability to be reported in SFP	<u>2,500</u>	<i>Provided in information</i>
<b>Situation 2</b>		
Opening deferred tax liability	\$ 1,500	<i>Provided in trial balance</i>
Increase in the year to be taken to IS as an increase in tax expense	1,000	<i>Provided in information</i>
Closing deferred tax liability to be reported in SFP	<u>2,500</u>	<i>Balancing figure</i>
<b>Situation 3</b>		
Opening deferred tax liability	\$ 1,500	<i>Provided in trial balance</i>
Increase in the year to be taken to IS as an increase in tax expense	1,000	<i>Balancing figure</i>
Closing deferred tax liability to be reported in SFP	<u>2,500</u>	<i>Calculated from information (25% x \$10,000)</i>
<b>Situation 4</b>		
Opening deferred tax liability	\$ 1,500	<i>Provided in trial balance</i>
Increase in the year to be taken to IS as an increase in tax expense	1,000	<i>Calculated from information (25% x \$4,000)</i>
Closing deferred tax liability to be reported in SFP	<u>2,500</u>	<i>Balancing figure</i>

Situations 1 and 2 are both giving a figure that can be slotted straight into the deferred tax working. In situations 3 and 4 however, the temporary differences are being given. These are then used to calculate a figure which can be slotted into the working. In all situations, the missing figure is calculated as a balancing figure. Table 4 shows the completed workings.

### Revaluations of non-current assets

Revaluations of non-current assets (NCA) are a further example of a taxable temporary difference. When an NCA is revalued to its current value within the financial statements, the revaluation surplus is recorded in equity (in a revaluation reserve) and reported as other comprehensive income. While the carrying amount of the asset has increased, the tax base of the asset remains the same and so a temporary difference arises.

Tax will become payable on the surplus when the asset is sold and so the temporary difference is taxable. Since the revaluation surplus has been recognised within equity, to comply with matching, the tax charge on the surplus is also charged to equity. Suppose that in Example 1, the asset is revalued to \$2,500 at the end of year 2, as shown in Table 5.

TABLE 5: REVALUED ASSET AT THE END OF YEAR 2 (EXAMPLE 1)

Year 2	Carrying value (Cost - accumulated depreciation)	Tax base (Cost - accumulated capital allowances)	Temporary difference
	\$	\$	\$
Opening balance	1,500	1,200	300
Depreciation charge/capital allowance	(500)	(600)	100
Revaluation	1,500	-	1,500
Closing Balance	2,500	600	1,900

The carrying amount will now be \$2,500 while the tax base remains at \$600. There is, therefore, a temporary difference of \$1,900, of which \$1,500 relates to the revaluation surplus. This gives rise to a deferred tax liability of  $25\% \times \$1,900 = \$475$  at the year-end to report in the Statement of Financial Position. The liability was \$75 at the start of the year ( Example 1) and thus there is an increase of \$400 to record.

However, the increase in relation to the revaluation surplus of  $25\% \times \$1,500 = \$375$  will be charged to the revaluation reserve and reported within other comprehensive income. The remaining increase of \$25 will be charged to the Statement of Profit or Loss as before.

The overall double entry is:

Dr	Tax expense in Statement of Profit or Loss	\$25
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Dr	Revaluation reserve in equity	\$375
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Cr	Deferred tax liability in SFP	\$400
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## The SBR exam

It is important to appreciate that deferred tax can arise in respect of many different types of asset or liability and not just non-current assets as discussed above. Therefore, for SBR it is more important that candidates understand the principles behind deferred tax so that they can be applied to any given situation. Some of the situations that may be seen are discussed below. In all of the following situations, assume that the applicable tax rate is 25%.

### Deferred tax assets

It is important to be aware that temporary differences can result in needing to record a deferred tax asset instead of a liability. Temporary differences affect the timing of when tax is paid or when tax relief is received. While normally they result in the payment being deferred until the future or relief being received in advance (and hence a deferred tax liability) they can result in the payment being accelerated or relief being due in the future.

In these latter situations the temporary differences result in a deferred tax asset arising (or where the entity has other larger temporary differences that create deferred tax liabilities, a reduced deferred tax liability).

Whether an individual temporary difference gives rise to a deferred tax asset or liability can be ascertained by applying the following rule:

Carrying amount of asset / Tax base of asset / Temporary difference  
(Liability) (Liability) =

If the temporary difference is positive, a deferred tax liability will arise. If the temporary difference is negative, a deferred tax asset will arise.

TABLE 6: IMPAIRMENT OF NON-CURRENT ASSET (EXAMPLE 3)			
Carrying value of the asset	Tax base of the asset	Temporary difference	Deferred tax asset or liability?
\$ 2,800	\$ 3,500	\$ (700)	Asset

  

TABLE 7: WRITE DOWN OF INVENTORY (EXAMPLE 4)			
Carrying value of the asset	Tax base of the asset	Temporary difference	Deferred tax asset or liability?
\$ 9,000	\$ 10,000	\$ (1,000)	Asset

  

TABLE 8: ACCRUED PENSION CONTRIBUTIONS (EXAMPLE 5)			
Carrying value of the asset	Tax base of the asset	Temporary difference	Deferred tax asset or liability?
\$ (25,000)	\$ Nil	\$ (25,000)	Asset

### EXAMPLE 3

Suppose that at the reporting date the carrying amount of a non-current asset is \$2,800 while its tax base is \$3,500, as shown in Table 6 above.

In this scenario, the carrying amount of the asset has been written down to below the tax base. This might be because an impairment loss has been recorded on the asset which is not allowable for tax purposes until the asset is sold. The entity will therefore receive tax relief on the impairment loss in the future when the asset is sold.

The deferred tax asset at the reporting date will be  $25\% \times \$700 = \$175$ .

It is worth noting here that revaluation gains, which increase the carrying amount of the asset and leave the tax base unchanged, result in a deferred tax liability. Conversely, impairment losses, which decrease the carrying amount of the asset and leave the tax base unchanged, result in a deferred tax asset.

### EXAMPLE 4

At the reporting date, inventory which cost \$10,000 has been written down to its net realisable value of \$9,000. The write down is ignored for tax purposes until the goods are sold.

The write off of inventory will generate tax relief, but only in the future when the goods are sold. Hence the tax base of the inventory is not reduced by the write off. Consequently, a deferred tax asset of  $25\% \times \$1,000 = \$250$  as shown in Table 8 should be recorded at the reporting date.

**EXAMPLE 5**

At the reporting date, an entity has recorded a liability of \$25,000 in respect of pension contributions due. Tax relief is available on pension contributions only when they are paid.

The contributions will only be recognised for tax purposes when they are paid in the future. Hence the pension expense is currently ignored within the tax computations and so the liability has a nil tax base, as shown in Table 8. The entity will receive tax relief in the future and so a deferred tax asset of  $25\% \times \$25,000 = \$6,250$  should be recorded at the reporting date.

**Group financial statements**

When dealing with deferred tax in group financial statements, it is important to remember that a group does not legally exist and so is not subject to tax. Instead, tax is levied on the individual legal entities within the group and their individual tax assets and liabilities are cross-cast in the consolidation process. To calculate the deferred tax implications on consolidation adjustments when preparing the group financial statements, the carrying amount refers to the carrying amount within the group financial statements while the tax base will be the tax base in the entities' individual financial statements.

***Fair value adjustments***

At the date of acquisition, a subsidiary's net assets are measured at fair value. The fair value adjustments may not alter the tax base of the net assets and hence a temporary difference may arise. Any deferred tax asset/liability arising as a result is included within the fair value of the subsidiary's net assets at acquisition for the purposes of calculating goodwill.

***Goodwill***

Goodwill only arises on consolidation – it is not recognised as an asset within the individual financial statements. Theoretically, goodwill gives rise to a temporary difference that would

result in a deferred tax liability as it is an asset with a carrying amount within the group financial statements but will have a nil tax base. However, IAS 12 specifically excludes a deferred tax liability being recognised in respect of goodwill.

***Provisions for unrealised profits (PUPs)***

When goods are sold between group companies and remain in the inventory of the buying company at the year-end, an adjustment is made to remove the unrealised profit from the consolidated financial statements. This adjustment also reduces the inventory to the original cost when a group company first purchased it. However, the tax base of the inventory will be based on individual financial statements and so will be at the higher transfer price. Consequently, a deferred tax asset will arise. Recognition of the asset and the consequent decrease in the tax expense will ensure that the tax already charged to the individual selling company is not reflected in the current year's consolidated Statement of Profit or Loss but will be matched against the future period when the profit is recognised by the group.

**EXAMPLE 6**

P owns 100% of the equity share capital of S. P sold goods to S for \$1,000 recording a profit of \$200. All of the goods remain in the inventory of S at the year-end. Table 9 shows that a deferred tax asset of  $25\% \times \$200 = \$50$  should be recorded within the group financial statements.

**Measurement of deferred tax**

IAS 12 states that deferred tax assets and liabilities should be measured based on the tax rates that are expected to apply when the asset/liability will be realised/settled. Normally, current tax rates are used to calculate deferred tax on the basis that they are a reasonable approximation of future tax rates and that it would be too unreliable to estimate future tax rates.

Deferred tax assets and liabilities represent future taxes that will be recovered or that will be payable. It may therefore be expected that they should be discounted to reflect the time value of money, which would be consistent with the way in which other liabilities are measured. IAS 12, however, does not permit or allow the discounting of deferred tax assets or liabilities on practical grounds.

TABLE 9: PROVISION FOR UNREALISED PROFITS (EXAMPLE 6)

	Carrying value of the asset within group accounts	Tax base of the asset in individual entity accounts	Temporary difference	Deferred tax asset or liability?
	\$	\$	\$	
Cost to S	1,000			
PUP	(200)			
	<u>800</u>	1,000	(200)	Asset

The primary reason behind this is that it would be necessary for entities to determine when the future tax would be recovered or paid. In practice this is highly complex and subjective. Therefore, to require discounting of deferred tax liabilities would result in a high degree of unreliability. Furthermore, to allow but not require discounting would result in inconsistency and so a lack of comparability between entities.

### Deferred tax and the framework

As we have seen, IAS 12 considers deferred tax by taking a “balance sheet” approach to the accounting problem by considering temporary differences in terms of the difference between the carrying amounts and the tax values of assets and liabilities – also known as the valuation approach. This can be said to be consistent with the approach taken to recognition in the International Accounting Standards Board’s Conceptual Framework for Financial Reporting® (the Conceptual Framework). However, the valuation approach is applied regardless of whether the resulting deferred tax will meet the definition of an asset or liability in its own right.

Thus, IAS 12 considers the overriding accounting issue behind deferred tax to be the application of matching – ensuring that the tax consequences of an item reported within the financial statements are reported in the same accounting period as the item itself.

For example, in the case of a revaluation surplus, since the gain has been recognised in the financial statements, the tax consequences of this gain should also be recognised – that is to say, a tax charge. In order to recognise a tax charge, it is necessary to complete the double entry by also recording a corresponding deferred tax liability.

However, part of the Conceptual Framework’s definition of a liability is that there is a ‘present obligation’. Therefore, the deferred tax liability arising on the revaluation gain should represent the current obligation to pay tax in the future when the asset is sold. However, since there is no present obligation to sell the asset, there is no present obligation to pay the tax.

Therefore, it is also acknowledged that IAS 12 is inconsistent with the Conceptual

Framework to the extent that a deferred tax asset or liability does not necessarily meet the definition of an asset or liability.

**Sally Baker and Tom Clendon are tutors at Kaplan Financial**

**Chapter 6 IFRS 2, Share-based Payment**

## Executive Summary

International Financial Reporting Standard (IFRS®) 2, Share-based Payment, applies when a company acquires or receives goods and services for equity-based payment.

These goods can include inventories, property, plant and equipment, intangible assets, and other non-financial assets. There are two notable exceptions: shares issued in a business combination, which are dealt with under IFRS 3, *Business Combinations*; and contracts for the purchase of goods that are within the scope of International Accounting Standard (IAS®) 32 and IAS 39. In addition, a purchase of treasury shares would not fall within the scope of IFRS 2, nor would a rights issue where some of the employees are shareholders.

Examples of some of the arrangements that would be accounted for under IFRS 2 include call options, share appreciation rights, share ownership schemes, and payments for services made to external consultants based on the company's equity capital.

## Recognition of share-based payment

IFRS 2 requires an expense to be recognised for the goods or services received by a company. The corresponding entry in the accounting records will either be a liability or an increase in the equity of the company, depending on whether the transaction is to be settled in cash or in equity shares. Goods or services acquired in a share-based payment transaction should be recognised when they are received. In the case of goods, this is obviously the date when this occurs. However, it is often more difficult to determine when services are received. If shares are issued that vest immediately, then it can be assumed that these are in consideration of past services. As a result, the expense should be recognised immediately.

Alternatively, if the share options vest in the future, then it is assumed that the equity instruments relate to future services and recognition is therefore spread over that period.

## Equity settled transactions

Equity-settled transactions with employees and directors would normally be expensed and would be based on their fair value at the grant date. Fair value should be based on market price wherever this is possible. Many shares and share options will not be traded on an active market. If this is the case then valuation techniques, such as the option pricing model, would be used. IFRS 2 does not set out which pricing model should be used, but describes the factors that should be taken into account. It says that 'intrinsic value' should only be used where the fair value cannot be reliably estimated. Intrinsic value is the

difference between the fair value of the shares and the price that is to be paid for the shares by the counterparty.

The objective of IFRS 2 is to determine and recognise the compensation costs over the period in which the services are rendered. For example, if a company grants share options to employees that vest in the future only if they are still employed, then the accounting process is as follows:

- The fair value of the options will be calculated at the date the options are granted.
- This fair value will be charged to profit or loss equally over the vesting period, with adjustments made at each accounting date to reflect the best estimate of the number of options that will eventually vest.
- Shareholders' equity will be increased by an amount equal to the charge in profit or loss. The charge in the income statement reflects the number of options vested. If employees decide not to exercise their options, because the share price is lower than the exercise price, then no adjustment is made to profit or loss. On early settlement of an award without replacement, a company should charge the balance that would have been charged over the remaining period.

### **EXAMPLE 1**

A company issued share options on 1 June 20X6 to pay for the purchase of inventory. The inventory is eventually sold on 31 December 20X8. The value of the inventory on 1 June 20X6 was \$6m and this value was unchanged up to the date of sale. The sale proceeds were \$8m. The shares issued have a market value of \$6.3m.

How will this transaction be dealt with in the financial statements?

### **Answer**

IFRS 2 states that the fair value of the goods and services received should be used to value the share options unless the fair value of the goods cannot be measured reliably. Thus equity would be increased by \$6m and inventory increased by \$6m. The inventory value will be expensed on sale.

## **Performance conditions**

Schemes often contain conditions which must be met before there is entitlement to the shares. These are called vesting conditions. If the conditions are specifically related to the market price of the company's shares then such conditions are ignored for the purposes of

estimating the number of equity shares that will vest. The thinking behind this is that these conditions have already been taken into account when fair valuing the shares. If the vesting or performance conditions are based on, for example, the growth in profit or earnings per share, then it will have to be taken into account in estimating the fair value of the option at the grant date.

**EXAMPLE 2**

A company grants 2,000 share options to each of its three directors on 1 January 20X6, subject to the directors being employed on 31 December 20X8. The options vest on 31 December 20X8. The fair value of each option on 1 January 20X6 is \$10, and it is anticipated that on 1 January 20X6 all of the share options will vest on 30 December 20X8. The options will only vest if the company's share price reaches \$14 per share.

The share price at 31 December 20X6 is \$8 and it is not anticipated that it will rise over the next two years. It is anticipated that on 31 December 20X6 only two directors will be employed on 31 December 20X8.

How will the share options be treated in the financial statements for the year ended 31 December 20X6?

**Answer**

The market-based condition (ie the increase in the share price) can be ignored for the purpose of the calculation. However the employment condition must be taken into account. The options will be treated as follows:

$$2,000 \text{ options} \times 2 \text{ directors} \times \$10 \times 1 \text{ year} / 3 \text{ years} = \$13,333$$

Equity will be increased by this amount and an expense shown in profit or loss for the year ended 31 December 20X6.

## Cash settled transactions

Cash settled share-based payment transactions occur where goods or services are paid for at amounts that are based on the price of the company's equity instruments. The expense for cash settled transactions is the cash paid by the company.

As an example, share appreciation rights entitle employees to cash payments equal to the increase in the share price of a given number of the company's shares over a given period. This creates a liability, and the recognised cost is based on the fair value of the instrument at the reporting date. The fair value of the liability is re-measured at each reporting date until settlement.

**EXAMPLE 3**

Jay, a public limited company, has granted 300 share appreciation rights to each of its 500 employees on 1 July 20X5. The management feel that as at 31 July 20X6, the year end of Jay, 80% of the awards will vest on 31 July 20X7. The fair value of each share appreciation right on 31 July 20X6 is \$15.

What is the fair value of the liability to be recorded in the financial statements for the year ended 31 July 20X6?

**Answer**

$300 \text{ rights} \times 500 \text{ employees} \times 80\% \times \$15 \times 1 \text{ year} / 2 \text{ years} = \$900,000$

## Deferred tax implications

In some jurisdictions, a tax allowance is often available for share-based transactions. It is unlikely that the amount of tax deducted will equal the amount charged to profit or loss under the standard. Often, the tax deduction is based on the option's intrinsic value, which is the difference between the fair value and exercise price of the share. A deferred tax asset will therefore arise which represents the difference between a tax base of the employee's services received to date and the carrying amount, which will effectively normally be zero. A deferred tax asset will be recognised if the company has sufficient future taxable profits against which it can be offset.

For cash settled share-based payment transactions, the standard requires the estimated tax deduction to be based on the current share price. As a result, all tax benefits received (or expected to be received) are recognised in the profit or loss.

**EXAMPLE 4**

A company operates in a country where it receives a tax deduction equal to the intrinsic value of the share options at the exercise date. The company grants share options to its employees with a fair value of \$4.8m at the grant date. The company receives a tax

allowance based on the intrinsic value of the options which is \$4.2m. The tax rate applicable to the company is 30% and the share options vest in three-years' time.

**Answer**

A deferred tax asset would be recognised of:

\$4.2m @ 30% tax rate x 1 year / 3 years = \$420,000

The deferred tax will only be recognised if there are sufficient future taxable profits available.

## Disclosure

IFRS 2 requires extensive disclosures under three main headings:

- Information that enables users of financial statements to understand the nature and extent of the share-based payment transactions that existed during the period.
- Information that allows users of financial statements to understand how the fair value of the goods or services received, or the fair value of the equity instruments which have been granted during the period, was determined.
- Information that allows users of financial statements to understand the effect of expenses, which have arisen from share-based payment transactions, on the entity's profit or loss in the period.

The standard is applicable to equity instruments granted after 7 November 2002 but not yet vested on the effective date of the standard, which is 1 January 2005. IFRS 2 applies to liabilities arising from cash-settled transactions that existed at 1 January 2005.

SBR candidates need to be comfortable with the above accounting principles and be able to explain them in the context of some accounting numbers.

**Written by a member of the *Strategic Business Reporting* examining team**

**Chapter 7 IFRS 9, Financial instruments**

## Executive Summary

IFRS® 9, Financial Instruments represents the outcome of work to date undertaken by the International Accounting Standards Board (the Board) in conjunction with the Financial Accounting Standards Board (FASB) in the US to improve and converge financial reporting standards.

The issue of IFRS® 9, *Financial Instruments* is part of the project to replace IAS® 39, *Financial Instruments – Recognition and Measurement*.

It was issued in November 2009 and initially dealt with classification and measurement of financial assets. IFRS 9 was subsequently updated in October 2010 to include accounting for financial liabilities.

IFRS 9 is effective for accounting periods commencing on or after 1 January 2013, with earlier application possible. Note that further developments are in progress dealing with impairment, derivatives and hedging. To the extent that IFRS 9 does not yet deal with a particular issue, the requirements of IAS 39 continue to apply.

This article focuses on the accounting requirements relating to financial assets and financial liabilities only. Other aspects of accounting for financial instruments, such as hedging arrangements, will be considered in a separate article.

Arguably, IFRS 9 has simplified and improved accounting for financial assets in comparison with its predecessor, IAS 39. The number of classifications has been reduced from four to three, as the available-for-sale classification has not been retained within IFRS 9. This has consequently resulted in elimination of the requirement to recycle gains and losses previously taken to equity upon derecognition of the financial asset, bringing the benefit of reduced complexity of financial reporting information.

There is increased emphasis on fair value accounting and reporting, which is regarded as both relevant and reliable information to those interested in financial reports. IFRS 9 has also reduced the degree of discretion for classification and accounting treatment of financial assets, which should support consistent reporting of financial information relating to financial assets and enhance understanding and comparability of that information.

If we begin with the classification of financial assets, IFRS 9 now classifies financial assets under three headings as follows:

## Classification of financial assets

**(1) Financial assets at fair value through profit or loss (FVTPL)**

This is the normal default classification for financial assets and will apply to all financial assets unless they are designated to be measured and accounted for in any other way. This classification includes any financial assets held for trading purposes and also derivatives, unless they are part of a properly designated hedging arrangement. Debt instruments will be classified to be measured and accounted for at FVTPL unless they have been correctly designated to be measured at amortised cost (see later). Initial recognition at fair value is normally cost incurred and this will exclude transactions costs, which are charged to profit or loss as incurred. Remeasurement to fair value takes place at each reporting date, with any movement in fair value taken to profit or loss for the year, which effectively incorporates an annual impairment review.

**(2) Financial assets at fair value through other comprehensive income (FVTOCI)**

This classification applies to equity instruments only and must be designated upon initial recognition. It will typically be applicable for equity interests that an entity intends to retain ownership of on a continuing basis. Initial recognition at fair value would normally include the associated transaction costs of purchase. The accounting treatment automatically incorporates an impairment review, with any change in fair value taken to other comprehensive income in the year.

Upon derecognition, any gain or loss is based upon the carrying amount at the date of disposal. One important point is that there is no recycling of any amounts previously taken to equity in earlier accounting periods. Instead, at derecognition, an entity may choose to make an equity transfer from other components of equity to retained earnings as any amounts previously taken to equity can now be regarded as having been realised.

**(3) Financial assets measured at amortised cost**

This classification can apply only to debt instruments and must be designated upon initial recognition. For the designation to be effective, the financial asset must pass two tests as follows:

- The business model test – to pass this test, the entity must be holding the financial asset to collect in the contractual cash flows associated with that financial asset. If this is not the case, such as the financial asset being held and then traded to take advantage of changes in fair value, then the test is failed and the financial asset reverts to the default classification to be measured at FVTPL.
- The cash flow characteristics test – to pass this test, the contractual cash flows collected must consist solely of payment of interest and capital. If this is not the case, the test is failed and the financial asset reverts to the default classification to be measured at FVTPL.

One example of a financial asset that would fail this test is a convertible bond. While there is receipt of the nominal rate of interest payable by the bond issuer, and the bond will be converted into shares or cash at a later date, the cash flows are affected by the fact that the bond holder has a choice to make at some later date – either to receive shares or cash at the time the bond is redeemed. The nominal rate of interest received will be lower than for an equivalent financial asset without conversion rights to reflect the right of choice the bondholder will make at some later date.

This classification of financial asset requires annual review for evidence of possible impairment and, if there is evidence, there must be an impairment review. Any impairment identified must be charged to profit or loss in full immediately.

One problem that may arise in relation to financial assets measured at fair value is whether a reliable fair value can be determined at the reporting date. For exchange-traded financial assets, such as equity shares in a listed entity, this may be a relatively straightforward process. If, however, the financial assets in question are not traded on an exchange, there may be no definitive method to determine fair value at a particular date. This could result in the exercise of judgment or discretion, which could undermine the reliability or relevance of any amounts accounted for as a fair value.

**Illustration 1 – classification and measurement of financial assets**

An entity, Suarez, purchased a five-year bond on 1 January 2010 at a cost of \$5m with annual interest of 5%, which is also the effective rate, payable on 31 December annually. At the reporting date of 31 December 2010 interest has been received as expected and the market rate of interest is now 6%.

Required:

Account for the financial asset at 31 December 2010 on the basis that:

- (i) it is classified as FVTPL, and
- (ii) it is classified to be measured at amortised cost, on the assumption it passes the necessary tests and has been properly designated at initial recognition.

Answer:

- (i) If classified as FVTPL

This requires that the fair value of the bond is measured based upon expected future cash flows discounted at the current market rate of interest of 6% as follows:

Year	Expected cash flows	6% discount factor	Present value \$m
31 December 2011	\$5m x 5% = \$0.25m	0.9434	0.2358
31 December 2012	\$0.25m	0.8900	0.2225
31 December 2013	\$0.25m	0.8396	0.2099
31 December 2014	\$0.25m + \$5m	0.7921	<u>4.1585</u>
			4.8267

Therefore, at the reporting date of 31 December 2010, the financial asset will be stated at a fair value of \$4.8267m, with the fall in fair value amounting to \$0.1733m taken to profit or loss in the year. Interest received will be taken to profit or loss for the year amounting to \$0.25m.

(ii) If classified to be measured at amortised cost

This requires that the fair value of the bond is measured based upon expected future cash flows discounted at the original effective rate of 5%. This will continue to be at \$5m as the following calculation confirms:

Year	Expected cash flows	5% discount factor	Present value \$m
31 December 2011	\$5m x 5% = \$0.25m	0.9524	0.2381
31 December 2012	\$0.25m	0.9070	0.2267
31 December 2013	\$0.25m	0.8638	0.2160
31 December 2014	\$0.25m + \$5m	0.8227	<u>4.3192</u>
			5,0000

In addition, interest received during the year of \$0.25m will be taken to profit or loss for the year.

## Impairment of financial assets

IFRS 9 effectively incorporates an impairment review for financial assets that are measured at fair value, as any fall in fair value is taken to profit or loss or other comprehensive income for the year, depending upon the classification of the financial asset (see earlier).

For financial assets designated to be measured at amortised cost, an entity must make an

assessment at each reporting date whether there is evidence of possible impairment; if there is, then an impairment review should be performed. If impairment is identified, it is charged to profit or loss immediately. Quantification of the recoverable amount would normally be based upon the present value of the expected future cash flows estimated at the date of the impairment review and discounted to their present value based on the original effective rate of return at the date the financial asset was issued.

### Illustration 2 – impairment of financial assets measured at amortised cost

Using the information contained within Illustration 1, where the carrying amount of the financial asset at 31 December 2010 was \$5m. If, in early 2011, it was identified the bond issuer was beginning to experience financial difficulties, and there was doubt regarding full recovery of the amounts due to Suarez, an impairment review would be required. The expected future cash flows now expected by Suarez from the bond issuer are as follows:

Year	Expected cash flows
31 December 2011	\$0.20m
31 December 2012	\$0.20m
31 December 2013	\$0.20m
31 December 2014	\$0.20m + \$4.4m

Required: Calculate the extent of impairment of the financial asset to be included in the financial statements of Suarez for the year ending 31 December 2011.

Answer: The future cash flows now expected are discounted to present value based on the original effective rate associated with the financial asset of 5% as follows:

Year	Expected cash flows	5% discount factor	Present value \$m
31 December 2011	\$0.20m	0.9524	0.1905
31 December 2012	\$0.20m	0.9070	0.1814
31 December 2013	\$0.20m	0.8638	0.1727
31 December 2014	\$0.20m + \$4.4m	0.8227	<u>3.7844</u>
			4,3290

Therefore, impairment amounting to the change in carrying value of (\$5.0m – \$4.329m) \$0.671m will be recognised as an impairment charge in the year to 31 December 2011. Additionally, there will also be recognition of interest receivable in the statement of comprehensive income for the year amounting to (4.329m x 5%) \$0.2165m.

Both the Board and FASB in the US continue their work on accounting for impairment of financial assets, with a reporting standard expected before the end of 2011.

## Classification of financial liabilities

IFRS 9 was updated in October 2010 to include recognition and measurement of financial liabilities. Essentially, the requirements of IAS 39 in relation to financial liabilities are now contained in IFRS 9 and require that financial liabilities should be accounted for as follows:

1. Financial liabilities at fair value through profit or loss (FVTPL): like the equivalent classification for financial assets, this will include financial liabilities incurred for trading purposes and also derivatives that are not part of a hedging arrangement.
2. Other financial liabilities measured at amortised cost: if financial liabilities are not measured at FVTPL, they are measured at amortised cost.

IFRS 9 also retains the option for some liabilities, which would normally be measured at amortised cost to be measured at FVTPL if, in doing so, it eliminates or reduces an accounting mismatch, sometimes referred to as 'the fair value option'. Where this is the case, to the extent that part of the change in fair value of the financial liability is due to a change in the entity's own credit risk, this should be taken to other comprehensive income in the year, with the balance of any change in fair value taken to profit or loss. If this accounting treatment for the credit risk creates or enlarges an accounting mismatch in profit or loss then the gain or loss relating to credit risk should also be taken to profit or loss.

## Summary

The overall impact of IFRS 9 is that there is likely to be increased emphasis on fair value accounting for financial assets, rather than the use of other forms of measurement such as amortised cost or historical cost. In addition, accounting for impairment of financial assets has become less complex.

There have been no significant changes to accounting for financial liabilities.

**Tony Sweetman is a content specialist and tutor at Kaplan Publishing and Kaplan Financial**

## **Chapter 8 IFRS 13, Fair Value Measurement**

### Executive Summary

IFRS 13 has required a significant amount of work by entities to simply understand the nature of the principles and concepts involved.

IFRS® 13, *Fair Value Measurement* was issued in May 2011 and defines fair value, establishes a framework for measuring fair value and requires significant disclosures relating to fair value measurement. The International Accounting Standards Board (the Board) wanted to enhance disclosures for fair value in order that users could better assess the valuation techniques and inputs that are used to measure fair value. There are no new requirements as to when fair value accounting is required but rather it relies on guidance regarding fair value measurements in existing standards.

The guidance in IFRS 13 does not apply to transactions dealt with by certain standards. For example share based payment transactions in IFRS 2, *Share-based Payment*, leasing transactions in IFRS 16, *Leases*, or to measurements that are similar to fair value but are not fair value – for example, net realisable value calculations in IAS®2, *Inventories* or value in use calculations in IAS 36, *Impairment of Assets*. Therefore, IFRS 13 applies to fair value measurements that are required or permitted by those standards not scoped out by IFRS 13. It replaces the inconsistent guidance found in various IFRS standards with a single source of guidance on measurement of fair value.

Historically, fair value has had a different meaning depending on the context and usage. The Board's definition of fair value is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. Basically it is an exit price. Consequently, fair value is focused on the assumptions of the market place, is not entity specific and so takes into account any assumptions about risk. This means that fair value is measured using the same assumptions used by market participants and takes into account the same characteristics of the asset or liability. Such conditions would include the condition and location of the asset and any restrictions on its sale or use.

Interestingly an entity cannot argue that prices are too low relative to its own valuation of the asset and that it would be unwilling to sell at low prices. The prices to be used are those in 'an orderly transaction'. An orderly transaction is one that assumes exposure to the market for a period before the date of measurement to allow for normal marketing activities to take place and to ensure that it is not a forced transaction. If the transaction is not 'orderly' then there will not have been enough time to create competition and potential buyers may reduce the price that they are willing to pay. Similarly if a seller is forced to accept a price in a short period of time, the price may not be representative. Therefore, it does not follow that a market in which there are few transactions is not orderly. If there has

been competitive tension, sufficient time and information about the asset, then this may result in an acceptable fair value.

IFRS 13 does not specify the unit of account that should be used to measure fair value. This means that it is left to the individual standard to determine the unit of account for fair value measurement. A unit of account is the single asset or liability or group of assets or liabilities. The characteristic of an asset or liability must be distinguished from a characteristic arising from the holding of an asset or liability by an entity. An example of this is where an entity sells a large block of shares, and it has to sell them at a discount price to the market price. This is a characteristic of holding the asset rather than a characteristic of the asset itself and should not be taken into account when fair valuing the asset.

Fair value measurement assumes that the transaction to sell the asset or transfer the liability takes place in the principal market for the asset or liability or, in the absence of a principal market, in the most advantageous market for the asset or liability. The principal market is the one with the greatest volume and level of activity for the asset or liability that can be accessed by the entity.

The most advantageous market is the one, which maximises the amount that would be received for the asset or paid to extinguish the liability after transport and transaction costs. Often these markets would be the same.

Sensibly an entity does not have to carry out an exhaustive search to identify either market but should take into account all available information. Although transaction costs are taken into account when identifying the most advantageous market, the fair value is calculated before adjustment for transaction costs because these costs are characteristics of the transaction and not the asset or liability. However, if location is a factor, then the market price is adjusted for the costs incurred to transport the asset to that market. Market participants must be independent of each other and knowledgeable, and able and willing to enter into transactions.

This is a complex process and so IFRS 13 sets out a valuation approach, which refers to a broad range of techniques, which can be used. There are three approaches based on the market, income and cost. When measuring fair value, the entity is required to maximise the use of observable inputs and minimise the use of unobservable inputs. To this end, the standard introduces a fair value hierarchy, which prioritises the inputs into the fair value measurement process

Fair value measurements are categorised into a three-level hierarchy, based on the type of inputs to the valuation techniques used, as follows:

- Level 1 inputs are unadjusted quoted prices in active markets for items identical to the asset or liability being measured. As with current IFRS standards, if there is a quoted price in an active market, an entity uses that price without adjustment when measuring fair value. An example of this would be prices quoted on a stock exchange. The entity needs to be able to access the market at the measurement date. Active markets are ones where transactions take place with sufficient frequency and volume for pricing information to be provided. An alternative method may be used where it is expedient. The standard sets out certain criteria where this may be applicable. For example where the price quoted in an active market does not represent fair value at the measurement date. An example of this may be where a significant event takes place after the close of the market such as a business reorganisation or combination.

The determination of whether a fair value measurement is based on level 2 or level 3 inputs depends on (i) whether the inputs are observable inputs or unobservable and (ii) their significance.

- Level 2 inputs are inputs other than the quoted prices in determined in level 1 that are directly or indirectly observable for that asset or liability. They are likely to be quoted assets or liabilities for similar items in active markets or supported by market data. For example interest rates, credit spreads or yields curves. Adjustments may be needed to level 2 inputs and, if this adjustment is significant, then it may require the fair value to be classified as level 3.
- Finally, level 3 inputs are unobservable inputs. These inputs should be used only when it is not possible to use Level 1 or 2 inputs. The entity should maximise the use of relevant observable inputs and minimise the use of unobservable inputs. However, situations may occur where relevant inputs are not observable and therefore these inputs must be developed to reflect the assumptions that market participants would use when determining an appropriate price for the asset or liability. The general principle of using an exit price remains and IFRS 13 does not preclude an entity from using its own data. For example cash flow forecasts may be used to value an entity that is not listed. Each fair value measurement is categorised based on the lowest level input that is significant to it.

IFRS 13 also sets out certain valuation concepts to assist in the determination of fair value. For non-financial assets only, fair value is determined based on the highest and best use of the asset as determined by a market participant. Highest and best use is a valuation

concept that considers how market participants would use a non-financial asset to maximise its benefit or value. The maximum value of a non-financial asset to market participants may come from its use in combination with other assets and liabilities or on a standalone basis. In determining the highest and best use of a non-financial asset, IFRS 13 indicates that all uses that are physically possible, legally permissible and financially feasible should be considered. As such, when assessing alternative uses, entities should consider the physical characteristics of the asset, any legal restrictions on its use and whether the value generated provides an adequate investment return for market participants.

The fair value measurement of a liability, or the entity's own equity, assumes that it is transferred to a market participant at the measurement date. In many cases there is no observable market to provide pricing information and the highest and best use is not applicable. In this case, the fair value is based on the perspective of a market participant who holds the identical instrument as an asset. If there is no corresponding asset, then a corresponding valuation technique may be used. This would be the case with a decommissioning activity. The fair value of a liability reflects the non performance risk based on the entity's own credit standing plus any compensation for risk and profit margin that a market participant might require to undertake the activity. Transaction price is not always the best indicator of fair value at recognition because entry and exit prices are conceptually different.

The guidance includes enhanced disclosure requirements that include:

- information about the hierarchy level into which fair value measurements fall
- transfers between levels 1 and 2
- methods and inputs to the fair value measurements and changes in valuation techniques, and
- additional disclosures for level 3 measurements that include a reconciliation of opening and closing balances, and quantitative information about unobservable inputs and assumptions used.

The above is a snapshot of a standard, which has required a significant amount of work by entities to simply understand the nature of the principles and concepts involved.

**Written by a member of the Strategic Business Reporting examining team**

## **Chapter 9    Impairment of financial assets**

### Executive Summary

This article considers the International Accounting Standards Board's proposals of new regulations for the impairment of financial assets.

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The International Accounting Standards Board (the Board) is proposing new regulations for the impairment of financial assets.

## Current regulation on the impairment of financial assets – the incurred loss approach

IAS® 39, *Financial Instruments: Recognition and Measurement* (IAS 39), does not require financial assets classified at fair value through profit or loss (FVTPL) and fair value through other comprehensive income (FVOCI) to be subject to impairment reviews. Therefore impairment reviews are only required in respect of financial assets that are classified as amortised cost – for example, loans, debt securities and trade receivables. Please see 'Related links' for the articles that I have previously written explaining these terms and the basic principles of accounting for financial instruments.

IAS 39 states that a financial asset is impaired and impairment losses are incurred only if a loss event has occurred and this loss event had a reliably measurable impact on the future cash flows. This is often called the 'incurred loss' approach.

The incurred loss approach has the advantage of being fairly objective – there has to have been a past event – for example, an actual default or a breach of a debt covenant. This objectivity reduces the risk of profit smoothing by companies as they are unable to estimate anticipated future losses. However, the incurred loss model has attracted criticism because it can result in the overstatement of both assets and profits. Arguably the incurred loss approach was a contributory factor in the credit crunch.

## Proposed regulation on the impairment of financial assets – the expected loss approach

The Board has proposed a model where credit losses on financial assets are no longer recognised when incurred but rather, are recognised on the basis of expected credit losses. This is often called the 'expected loss' approach.

The expected loss approach is likely to result in earlier recognition of credit losses, which includes not only losses that have already been incurred but also expected future losses. Arguably this method will be more prudent as both assets and profits will be reduced. It is however open to the criticism that allowing the judgment of what future losses might be incurred it will allow some companies to engage in profit smoothing.

Expected credit losses are defined as the expected shortfall in contractual cash flows. The estimation of expected credit losses should consider past events, current conditions and reasonable and supportable forecasts.

## Example of the expected loss approach

The Bale company has a portfolio of \$50,000 financial assets (debt instruments) that have two years to maturity and are correctly accounted for at amortised cost. Each asset has a coupon rate of 10% as well as an effective rate of 10%. No previous impairment loss has been recognised. At the year-end information has emerged that the sector in which the borrowers operate is experiencing tough economic conditions. It is now felt that a proportion of loans will default over the remaining loan period. After considering a range of possible outcomes, the overall rate of return from the portfolio is expected to be approximately 6% per annum for each of the next two years.

### **Required:**

**Calculate the expected credit losses on a life time basis.**

### **Answer**

The lender was expecting an annual return of \$5,000 a year ( $\$50,000 \times 10\%$ ) but is now only expecting an annual return of \$3,000 a year ( $\$50,000 \times 6\%$ ). There is therefore a shortfall – ie an expected credit loss shortfall of \$2,000 per year. An allowance should be calculated at the present value of the shortfalls over the remaining life of the asset.

The discount rate used should be between the risk-free rate and the effective rate of the asset. In the absence of further information, the effective rate of 10% has been used in the calculations below:

	Contractual cash flow shortfall \$	Discount rate \$	Present value \$
Year 1	2,000	0.909	1,818
Year 2	2,000	0.8264	<u>1,653</u>
			<u>3,471</u>

Thus, the expected credit loss is \$3,471. This is recognised as the impairment loss thus creating an expense to be charged to profit or loss and offset against the carrying value of the financial asset on the statement of financial position.

## Background to the proposals

In 2009, the Board published an exposure draft (ED) that proposed adjusting for expected impairment losses through adjusting the effective interest rate of a financial instrument. The basis for this model was that expected credit losses are usually priced into the interest rate to be charged and should be reflected in the yield on the financial asset. Changes in credit loss expectations were to be recognised as incurred as these changes would not have been priced into the asset. This works conceptually but is a little impracticable. In 2011, the Board proposed removing interest adjustment from the recognition of impairment losses

and adopting expected credit losses and this is the basis of the current ED issued in March 2013.

The ED applies to financial assets measured at amortised cost and at fair value through other comprehensive income. This includes debt instruments such as loans, debt securities and trade receivables. Additionally it applies to irrevocable loan commitments and financial guarantee contracts that are not accounted for at fair value through profit or loss under IFRS® 9 and also lease receivables. This is a wider scope than at present.

The principle behind the ED is that financial statements should reflect the general pattern of deterioration or improvement in the credit quality of financial assets within the scope of the ED. The Board's new proposals require the recognition of expected credit losses for certain financial assets by creating an allowance/provision based on either 12-month or lifetime expected credit losses. For financial assets, entities would recognise a loss allowance whereas for commitments to extend credit, a provision would be set up to recognise expected credit losses.

On initial recognition, an entity would create a credit loss allowance/provision equal to 12-months' expected credit losses. In subsequent years, if the credit risk increased significantly since initial recognition, this amount would be replaced by an estimate of the lifetime expected credit losses. Financial assets with a low credit risk would not meet the lifetime expected credit losses criterion. An entity does not recognise lifetime expected credit losses for financial assets that are equivalent to 'investment grade', which means that the asset has a low risk of default. Under the proposed model, there is a rebuttable presumption that lifetime expected losses should be provided for if contractual cash flows are 30 days overdue. If the credit quality subsequently improves and the lifetime expected credit losses criterion is no longer met, the credit loss reverts back to a 12-month expected credit loss basis. The entity can apply the ED on a collective basis, rather than on an individual basis, if the financial instruments share the same risk characteristics.

## Two stage approach

### **On initial recognition**

On the initial recognition of a financial asset an entity would recognise an impairment loss based on the 12-months' expected credit losses.

**On subsequent review**

Financial assets whose credit quality has not significantly deteriorated since their initial recognition; then the impairment loss is based on 12 months of expected credit losses.

Financial assets whose credit quality has significantly deteriorated since their initial recognition, then the impairment loss is based on a lifetime of expected credit losses.

Financial assets for which there is objective evidence of an impairment as at the reporting date, then the impairment loss is based on a lifetime of expected credit losses.

## Simplified approach

For trade receivables there is a simplified procedure in that no credit loss allowance is recognised on initial recognition. Any impairment loss will be the present value of the expected cash flow shortfalls over the remaining life of the receivables.

## Conclusion

The proposed change from the incurred loss model to an expected credit loss model will require more judgment as the carrying value of financial assets will be dependent on considering more forward-looking information which means that any losses would be accounted for earlier than happens under the current rules.

**Tom Clendon is a lecturer at FTMS based in Singapore and is the author of the second edition of *A Student's Guide to Group Accounts* (published by Kaplan Publishing)**

## **Chapter 10 Measurement**

### Executive Summary

This article considers the relevance of information provided by different measurement methods and explains the effect that they may have on the financial statements.

The relevance of information provided by a particular measurement method depends on how it affects the financial statements. The cost should be justified by the benefits of reporting that information to existing and potential users. The different measures used should be the minimum necessary to provide relevant information and there should be infrequent changes with any necessary changes clearly explained. Further it makes sense for comparability and consistency purposes, to use the same method for initial and subsequent measurement unless there is a good reason from not doing so.

The existing *Conceptual Framework for Financial Reporting*® (the framework) provides very little guidance on measurement, which constitutes a serious gap in the Framework. A single measurement basis may not provide the most relevant information to users and therefore IFRS® standards adopt a mixed measurement basis, which includes fair value, historical cost, and net realisable value. Different information from different measurement bases may be relevant in different circumstances. A particular measurement bases may be easier to understand, more verifiable and less costly to implement. However, if different measurement bases are used, it can be argued that the totals in financial statements have little meaning. Those that prefer a single measurement method favour the use of current values to provide the most relevant information.

A business that is profit orientated has processes to transform market input values (inventory for example) into market output values.(sales of finished products).Thus it makes sense that current values should play a key role in measurement. Current market value would appear to be the most relevant measure of assets and liabilities for financial reporting purposes.

The International Accounting Standards Board favour a mixed measurement approach whereby the most relevant measurement method is selected. It appears that investors feel that this approach is consistent with how they analyse financial statements and that the problems of mixed measurement are outweighed by the greater relevance achieved. In recent standards, it seems that the Board felt that fair value would not provide the most relevant information in all circumstances. For example, IFRS 9 requires the use of cost in some cases and fair value in other cases, while IFRS 15 essentially applies cost allocation.

A factor to be considered when selecting a measurement basis is the degree of measurement uncertainty. The Exposure Draft on the Conceptual Framework states that for some estimates, a high level of measurement uncertainty may outweigh other factors to such an extent that the resulting information may have little relevance. Most measurement is uncertain and requires estimation. For example, recoverable value for impairment,

depreciation estimates and fair value measures at level 2 and 3 under IFRS

13. Consequently, the Board believes that the level of uncertainty associated with the measurement of an item should be considered when assessing whether a particular measurement basis provides relevant information.

Measurement uncertainty could be considered too great with the result that the entity may not recognise the asset or liability. An example of this would be research activities. However, sometimes a measure with a high degree of uncertainty provides the most relevant information about an item. For example, financial instruments for which prices are not observable. The Board thinks that the level of measurement uncertainty that makes information lack relevance depends on the circumstances and can only be decided when developing particular standards.

It would be easier if measurement bases were categorised as either historical cost or current value. The Exposure Draft on the Conceptual Framework describes these two categories but also states that cash-flow-based measurement techniques are generally used to estimate the measure of an asset or a liability as part of a prescribed measurement basis. Cash-flow-based measurement can be used to customise measurement bases, which can result in more relevant information but it may also be more difficult for users to understand. As a result the Exposure Draft does not identify those techniques as a separate category.

There are several areas of debate about measurement. For example, should any discussion of measurement bases include the use of entry and exit values, entity-specific values and the role of deprival value. Again should an entity's business model affect the measurement of its assets and liabilities. Many would advocate that different measurement methods should be applied that are dependent both on the nature of assets and liabilities and also, importantly, on how these are used in the business. For example, property can be measured at historical cost or fair value depending upon the business model.

In order to meet the objective of financial reporting, information provided by a particular measurement basis must be useful to users of financial statements. A measurement basis achieves this if the information is relevant and faithfully represents what it essentially is supposed to represent. In addition, the measurement basis needs to provide information that is comparable, verifiable, timely and understandable. The Board believes that when selecting a measurement basis, the amount is more relevant if the way in which an asset or a liability contributes to future cash flows is considered. The Board considers that the way in

which an asset or a liability contributes to future cash flows depends, in part, on the nature of the business activities.

There are many different ways in which an asset or liability can be measured. Historical cost seems to be the easiest of these measures but even here, complexity can arise where there is a deferred payment or a payment, which involves an asset exchange. Subsequent accounting after initial recognition is not necessarily straightforward with historical cost as such matters as impairment of assets have to be taken into account and the latter is dependent upon rules, which can be sometimes subjective.

Current values have a variety of alternative valuation methods. These include market value, value-in-use and fulfilment value. Of these various methods, there is less ambiguity around current market prices as with any other measure of current value, there is likely to be specific rules in place to avoid inconsistency. In the main, the details of how these different measurement methods are applied, are set out in each accounting standard.

**Written by a member of the Strategic Business Reporting examining team**

## **Chapter 11 Revenue revisited – Part 1**

### Executive Summary

This two-part article considers the application of IFRS 15, Revenue from Contracts with Customers using the five-step model.

On 28 May 2014, the International Accounting Standards Board (the Board), as a result of the joint project with the US Financial Accounting Standards Board (FASB), issued IFRS® 15, *Revenue from Contracts with Customers*. Application of the standard is mandatory for annual reporting periods starting from 1 January 2017 onward (though there is currently a proposal to defer this date to 1 January 2018) and earlier application is permitted.

This article considers the application of IFRS 15, *Revenue from Contracts with Customers* using the five-step model. The new standard introduces some significant changes so you should ensure that you have the latest editions of all study materials.

Historically, there has been a significant divergence in practice over the recognition of revenue, mainly because IFRS standards have contained limited guidance in certain areas. The original standard, IAS® 18, *Revenue*, was issued in 1982 with a significant revision in 1993, however, IAS 18 was not fit for purpose in today's corporate world as the guidance available was difficult to apply to many transactions. The result was that some companies applied US GAAP when it suited their needs.

Users often found it difficult to understand the judgments and estimates made by an entity in recognising revenue, partly because of the 'boilerplate' nature of the disclosures. As a result of the varying recognition practices, the nature and extent of the impact of the new standard will vary between entities and industries. For many transactions, such as those in retail, the new standard will have little effect but there could be significant change to current practice in accounting for long-term and multiple-element contracts.

IFRS 15 replaces the following standards and interpretations:

- IAS 11, *Construction Contracts*
- IAS 18, *Revenue*
- IFRIC 13, *Customer Loyalty Programmes*
- IFRIC 15, *Agreements for the Construction of Real Estate*
- IFRIC 18, *Transfer of Assets from Customers*
- SIC-31, *Revenue – Barter Transactions Involving Advertising Services*

The core principle of IFRS 15 is that an entity shall recognise revenue from the transfer of promised good or services to customers at an amount that reflects the consideration to

which the entity expects to be entitled in exchange for those goods and services. The standard introduces a five-step model for the recognition of revenue.

## Using the five-step model

The five-step model applies to revenue earned from a contract with a customer with limited exceptions, regardless of the type of revenue transaction or the industry.

**Step one** in the five-step model requires the **identification of the contract** with the customer. Contracts may be in different forms (written, verbal or implied), but must be enforceable, have commercial substance and be approved by the parties to the contract. The model applies once the payment terms for the goods or services are identified and it is probable that the entity will collect the consideration. Each party's rights in relation to the goods or services have to be capable of identification. If a contract with a customer does not meet these criteria, the entity can continually reassess the contract to determine whether it subsequently meets the criteria.

Two or more contracts that are entered into around the same time with the same customer may be combined and accounted for as a single contract, if they meet the specified criteria. The standard provides detailed requirements for contract modifications. A modification may be accounted for as a separate contract or as a modification of the original contract, depending upon the circumstances of the case.

**Step two** requires the **identification of the separate performance obligations** in the contract. This is often referred to as 'unbundling', and is done at the beginning of a contract. The key factor in identifying a separate performance obligation is the distinctiveness of the good or service, or a bundle of goods or services. A good or service is distinct if the customer can benefit from the good or service on its own or together with other readily available resources and it is separately identifiable from other elements of the contract.

IFRS 15 requires that a series of distinct goods or services that are substantially the same with the same pattern of transfer, to be regarded as a single performance obligation. A good or service which has been delivered may not be distinct if it cannot be used without another good or service that has not yet been delivered. Similarly, goods or services that are not distinct should be combined with other goods or services until the entity identifies a bundle of goods or services that is distinct. IFRS 15 provides indicators rather than criteria to determine when a good or service is distinct within the context of the contract. This

allows management to apply judgment to determine the separate performance obligations that best reflect the economic substance of a transaction.

**Step three** requires the entity to **determine the transaction price**, which is the amount of consideration that an entity expects to be entitled to in exchange for the promised goods or services. This amount excludes amounts collected on behalf of a third party – for example, government taxes. An entity must determine the amount of consideration to which it expects to be entitled in order to recognise revenue.

The transaction price might include variable or contingent consideration. Variable consideration should be estimated as either the expected value or the most likely amount. The expected value approach represents the sum of probability-weighted amounts for various possible outcomes. The most likely amount represents the most likely amount in a range of possible amounts.

Management should use the approach that it expects will best predict the amount of consideration and it should be applied consistently throughout the contract. An entity can only include variable consideration in the transaction price to the extent that it is highly probable that a subsequent change in the estimated variable consideration will not result in a significant revenue reversal. If it is not appropriate to include all of the variable consideration in the transaction price, the entity should assess whether it should include part of the variable consideration. However, this latter amount still has to pass the ‘revenue reversal’ test.

Variable consideration is wider than simply contingent consideration as it includes any amount that is variable under a contract, such as performance bonuses or penalties.

Additionally, an entity should estimate the transaction price, taking into account non-cash consideration, consideration payable to the customer and the time value of money if a significant financing component is present. The latter is not required if the time period between the transfer of goods or services and payment is less than one year. In some cases, it will be clear that a significant financing component exists due to the terms of the arrangement.

In other cases, it could be difficult to determine whether a significant financing component exists. This is likely to be the case where there are long-term arrangements with multiple performance obligations such that goods or services are delivered and cash payments received throughout the arrangement. For example, if an advance payment is required for

business purposes to obtain a longer-term contract, then the entity may conclude that a significant financing obligation does not exist.

If an entity anticipates that it may ultimately accept an amount lower than that initially promised in the contract due to, for example, past experience of discounts given, then revenue would be estimated at the lower amount with the collectability of that lower amount being assessed. Subsequently, if revenue already recognised is not collectable, impairment losses should be taken to profit or loss.

**Step four** requires the **allocation of the transaction price to the separate performance obligations**. The allocation is based on the relative standalone selling prices of the goods or services promised and is made at the inception of the contract. It is not adjusted to reflect subsequent changes in the standalone selling prices of those goods or services.

The best evidence of standalone selling price is the observable price of a good or service when the entity sells that good or service separately. If that is not available, an estimate is made by using an approach that maximises the use of observable inputs – for example, expected cost plus an appropriate margin or the assessment of market prices for similar goods or services adjusted for entity-specific costs and margins or in limited circumstances a residual approach. The residual approach is different from the residual method that is used currently by some entities, such as software companies.

When a contract contains more than one distinct performance obligation, an entity should allocate the transaction price to each distinct performance obligation on the basis of the standalone selling price.

Where the transaction price includes a variable amount and discounts, it is necessary to establish whether these amounts relate to all or only some of the performance obligations in the contract. Discounts and variable consideration will typically be allocated proportionately to all of the performance obligations in the contract. However, if certain conditions are met, they can be allocated to one or more separate performance obligations.

This will be a major practical issue as it may require a separate calculation and allocation exercise to be performed for each contract. For example, a mobile telephone contract typically bundles together the handset and network connection and IFRS 15 will require their separation.

**Step five** requires **revenue to be recognised as each performance obligation is satisfied**. This differs from IAS 18 where, for example, revenue in respect of goods is recognised when the significant risks and rewards of ownership of the goods are transferred to the customer. An entity satisfies a performance obligation by transferring control of a promised good or service to the customer, which could occur over time or at a point in time. The definition of control includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. A performance obligation is satisfied at a point in time unless it meets one of the following criteria, in which case, it is deemed to be satisfied over time:

- The customer simultaneously receives and consumes the benefits provided by the entity's performance as the entity performs.
- The entity's performance creates or enhances an asset that the customer controls as the asset is created or enhanced.
- The entity's performance does not create an asset with an alternative use to the entity and the entity has an enforceable right to payment for performance completed to date.

Revenue is recognised in line with the pattern of transfer. Whether an entity recognises revenue over the period during which it manufactures a product or on delivery to the customer will depend on the specific terms of the contract.

If an entity does not satisfy its performance obligation over time, it satisfies it at a point in time and revenue will be recognised when control is passed at that point in time. Factors that may indicate the passing of control include the present right to payment for the asset or the customer has legal title to the asset or the entity has transferred physical possession of the asset.

As a consequence of the above, the timing of revenue recognition may change for some point-in-time transactions when the new standard is adopted.

In addition to the five-step model, IFRS 15 sets out how to account for the incremental costs of obtaining a contract and the costs directly related to fulfilling a contract and provides guidance to assist entities in applying the model to licences, warranties, rights of return, principal-versus-agent considerations, options for additional goods or services and breakage.

IFRS 15 is a significant change from IAS 18 and even though it provides more detailed application guidance, judgment will be required in applying it because the use of estimates is more prevalent.

For exam purposes, you should focus on understanding the principles of the five-step model so that you can apply them to practical questions.

**Written by a member of the Strategic Business Reporting examining team**

## **Chapter 12 Revenue revisited – Part 2**

### Executive Summary

This two-part article considers the application of IFRS 15, Revenue from Contracts with Customers using the five-step model.

This is the second part of an article looking at the key principles of IFRS 15, *Revenue from contracts with customers*.

The five-step model was explained in the first of this pair of articles. This article will explore the issues surrounding the definition and nature of a contract according to IFRS 15 in greater depth, as well as the scope of the standard and its interaction with other standards.

## Definition and nature of a contract

The definition of what constitutes a contract for the purpose of applying the standard is critical and is based on the definition of a contract in the US and is similar to that in IAS 32, *Financial Instruments: Presentation*. A contract exists when an agreement between two or more parties creates enforceable rights and obligations between those parties.

The agreement does not need to be in writing to be a contract, but the decision as to whether a contractual right or obligation is enforceable is considered within the context of the relevant legal framework of a jurisdiction.

Thus, whether a contract is enforceable will vary across jurisdictions. Indeed, the performance obligation could include promises that result in a valid expectation that the entity will transfer goods or services to the customer even though those promises are not legally enforceable.

IFRS 15 sets out five criteria that must be met before an entity can apply the revenue recognition model to that contract and these have been derived from previous revenue recognition and other standards. If some or all of these criteria are not met, then it is unlikely that the contract establishes enforceable rights and obligations. The criteria are assessed at the beginning of the contract and are not reassessed unless there has been a significant change in circumstances, which make the remaining contractual rights and obligations unenforceable.

The first of the criteria is that **the parties should have approved the contract and are committed to perform their respective obligations**. In the case of oral or implied contracts, this may be difficult, but all relevant facts and circumstances should be

considered in assessing the parties' commitment. The parties need not always be committed to fulfilling all of the obligations under a contract.

IFRS 15 gives the example where a customer is required to purchase a minimum quantity of goods, but past experience shows that the customer does not always do this and the other party does not enforce their contract rights. There needs to be evidence, however, that the parties are substantially committed to the contract. If IFRS 15 had required all of the obligations to be fulfilled, there would have been circumstances, as set out above, where revenue would not have been recognised, even though the parties were substantially committed to the contract.

The second and third criteria state that it is essential that **each party's rights and the payment terms can be identified regarding the goods or services to be transferred**. This latter requirement is the key to determining the transaction price. The construction industry was concerned as to whether it was possible to identify the payment terms for orders where the scope of work had been determined but the price of the work may not be decided for a period of time. These transactions are referred to as unpriced change orders or claims. IFRS 15 includes the need to determine whether the unpriced change order or contract claim should be accounted for on a prospective basis or a cumulative catch-up basis. If the scope of the work has been approved and the entity expects that the price will be approved, then revenue may be recognised.

The fourth criteria states that the **contract must have commercial substance** before revenue can be recognised as without this requirement, entities might artificially inflate their revenue and it would be questionable whether the transaction has economic consequences.

Finally, **it should be probable that the entity will collect the consideration due under the contract**. An assessment of a customer's credit risk is an important element in deciding whether a contract has validity, but customer credit risk does not affect the measurement or presentation of revenue. The consideration may be different to the contract price because of discounts and bonus offerings.

The entity should assess the ability of the customer to pay and the customer's intention to pay the consideration. In cases where the contract does not meet the criteria for recognition as a contract according to IFRS 15, the consideration received should only be recognised as revenue when the contract is either complete or cancelled, or until the contract meets all of the criteria for recognition.

IFRS 15 does not apply to wholly unperformed contracts where all parties have the enforceable right to end the contract without penalty. These contracts do not affect an entity's financial position until either party performs under the contract. The standard defines the term 'customer' as a 'party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration'. This is to distinguish contracts that should be accounted for under IFRS 15 from under other IFRSs.

Some respondents asked for a clarification of the meaning of ordinary activities, but none was given. Instead reference was made to the description of revenue in the IASB's *Conceptual Framework* and the FASB *Concepts Statement No 6*. An entity needs to consider all relevant facts and circumstances, such as the purpose of the activities undertaken by the other party, to determine whether that party is a customer.

At first sight this definition may seem relatively straightforward to apply; however, there are circumstances where an appropriate assessment is needed. For example, in cases where there is collaborative research and development between biotechnology and pharmaceutical entities, or grants received for research activity where the grantor specifies how the output from the research activity will be used. Additionally, it is possible that a joint arrangement accounted for under IFRS 11 *Joint Arrangements* could fall within the scope of IFRS 15 if the partner meets the definition of a customer.

In the case of the transfer of non-financial assets that are not an output of an entity's ordinary activities, it is now required that an entity applies IFRS 15 in order to determine when to derecognise the asset and to determine the gain or loss on derecognition. This is because these transactions are more like transfers of assets to customers, rather than other asset disposals.

IAS 18 did not provide specific guidance for variable consideration in these circumstances, but IFRS 15 does.

## Scope, exclusions and interactions with other standards

IFRS 15 excludes transactions involving non-monetary exchanges between entities in the same industry to facilitate sales to customers or to potential customers. It is common in the oil industry to swap inventory with another oil supplier to reduce transport costs and facilitate the sale of oil to the end customer. The party exchanging inventory with the entity

meets the definition of a customer, because of the contractual obligation which results in the party obtaining output of the entity's ordinary activities. In this situation, the recognition of revenue would not be appropriate as there would be an overstatement of revenue and costs.

Leases, insurance contracts, and financial instruments and other contractual rights or obligations within the scope of IFRS 9, *Financial Instruments*, IFRS 10, *Consolidated Financial Statements*, IFRS 11, *Joint Arrangements*, IAS 27, *Separate Financial Statements*, and IAS 28, *Investments in Associates and Joint Ventures*, are also scoped out in the standard. Some contracts with customers will fall partially under IFRS 15 and partially under other standards.

An example of this would be a lease arrangement with a service contract. If other IFRSs specify how to account for the contract, then the entity should first apply those IFRSs. The specific subject standard would take precedence in accounting for a part of a contract and any residual consideration should be accounted for under IFRS 15. Essentially, the transaction price will be reduced by the amounts that have been measured by the other standard.

As with all standards examined in the Diploma in International Financial Reporting exam, you should first aim to understand the principles of the standard, then make sure that you practice applying these to practical questions.

**Written by a member of the examining team**

**Chapter 13 When does debt seem to be equity**

## Executive Summary

The difference between debt and equity in an entity's statement of financial position is not easy to distinguish for preparers of financial statements. Many financial instruments have both features with the result that this can lead to inconsistency of reporting.

**The difference between debt and equity in an entity's statement of financial position is not easy to distinguish for preparers of financial statements. Many financial instruments have both features with the result that this can lead to inconsistency of reporting.**

The International Accounting Standards Board (the Board) agreed with respondents from its public consultation on its agenda (December 2012 report) that it needs greater clarity in its definitions of assets and liabilities for debt instruments. This should therefore help eliminate some uncertainty when accounting for assets and financial liabilities or non-financial liabilities. The respondents felt that defining the nature of liabilities would advance the Board's thinking on distinguishing between financial instruments that should be classified as equity and those instruments that should be classified as liabilities.

The objective of IAS® 32, *Presentation* is to establish principles for presenting financial instruments as liabilities or equity and for offsetting financial assets and liabilities. The classification of a financial instrument by the issuer as either debt or equity can have a significant impact on the entity's gearing ratio, reported earnings, and debt covenants. Equity classification can avoid such impact but may be perceived negatively if it is seen as diluting existing equity interests. The distinction between debt and equity is also relevant where an entity issues financial instruments to raise funds to settle a business combination using cash or as part consideration in a business combination.

Understanding the nature of the classification rules and potential effects is critical for management and must be borne in mind when evaluating alternative financing options. Liability classification normally results in any payments being treated as interest and charged to earnings, which may affect the entity's ability to pay dividends on its equity shares.

The key feature of debt is that the issuer is obliged to deliver either cash or another financial asset to the holder. The contractual obligation may arise from a requirement to repay principal or interest or dividends. Such a contractual obligation may be established explicitly or indirectly but through the terms of the agreement. For example, a bond that requires the issuer to make interest payments and redeem the bond for cash is classified as debt. In contrast, equity is any contract that evidences a residual interest in the entity's assets after deducting all of its liabilities. A financial instrument is an equity instrument only if the instrument includes no contractual obligation to deliver cash or another financial asset to another entity, and if the instrument will or may be settled in the issuer's own equity instruments.

For instance, ordinary shares, where all the payments are at the discretion of the issuer, are classified as equity of the issuer. The classification is not quite as simple as it seems. For example, preference shares required to be converted into a fixed number of ordinary shares on a fixed date, or on the occurrence of an event that is certain to occur, should be classified as equity.

A contract is not an equity instrument solely because it may result in the receipt or delivery of the entity's own equity instruments. The classification of this type of contract is dependent on whether there is variability in either the number of equity shares delivered or variability in the amount of cash or financial assets received. A contract that will be settled by the entity receiving or delivering a fixed number of its own equity instruments in exchange for a fixed amount of cash, or another financial asset, is an equity instrument. This has been called the 'fixed for fixed' requirement. However, if there is any variability in the amount of cash or own equity instruments that will be delivered or received, then such a contract is a financial asset or liability as applicable.

For example, where a contract requires the entity to deliver as many of the entity's own equity instruments as are equal in value to a certain amount, the holder of the contract would be indifferent whether it received cash or shares to the value of that amount. Thus, this contract would be treated as debt.

Other factors that may result in an instrument being classified as debt are:

- is redemption at the option of the instrument holder?
- is there a limited life to the instrument?
- is redemption triggered by a future uncertain event that is beyond the control of both the holder and issuer of the instrument?
- are dividends non-discretionary?

Similarly, other factors that may result in the instrument being classified as equity are whether the shares are non-redeemable, whether there is no liquidation date or where the dividends are discretionary.

The classification of the financial instrument as either a liability or as equity is based on the principle of substance over form. Two exceptions from this principle are certain puttable instruments meeting specific criteria and certain obligations arising on liquidation. Some instruments have been structured with the intention of achieving particular tax, accounting

or regulatory outcomes, with the effect that their substance can be difficult to evaluate.

The entity must make the decision as to the classification of the instrument at the time that the instrument is initially recognised. The classification is not subsequently changed based on changed circumstances. For example, this means that a redeemable preference share, where the holder can request redemption, is accounted for as debt even though legally it may be a share of the issuer.

In determining whether a mandatorily redeemable preference share is a financial liability or an equity instrument, it is necessary to examine the particular contractual rights attached to the instrument's principal and return elements. The critical feature that distinguishes a liability from an equity instrument is the fact that the issuer does not have an unconditional right to avoid delivering cash or another financial asset to settle a contractual obligation. Such a contractual obligation could be established explicitly or indirectly. However, the obligation must be established through the terms and conditions of the financial instrument. Economic necessity does not result in a financial liability being classified as a liability. Similarly, a restriction on the ability of an entity to satisfy a contractual obligation, such as the company not having sufficient distributable profits or reserves, does not negate the entity's contractual obligation.

Some instruments are structured to contain elements of both a liability and equity in a single instrument. Such instruments – for example, bonds that are convertible into a fixed number of equity shares and carry interest – are accounted for as separate liability and equity components. 'Split accounting' is used to measure the liability and the equity components upon initial recognition of the instrument. This method allocates the fair value of the consideration for the compound instrument into its liability and equity components. The fair value of the consideration in respect of the liability component is measured at the fair value of a similar liability that does not have any associated equity conversion option. The equity component is assigned the residual amount.

IAS 32 requires an entity to offset a financial asset and financial liability in the statement of financial position only when the entity currently has a legally enforceable right of set-off and intends either to settle the asset and liability on a net basis or to realise the asset and settle the liability simultaneously. An amendment to IAS 32 has clarified that the right of set-off must not be contingent on a future event and must be immediately available. It also must be legally enforceable for all the parties in the normal course of business, as well as in the event of default, insolvency or bankruptcy. Netting agreements, where the legal right of

offset is only enforceable on the occurrence of some future event – such as default of a party – do not meet the offsetting requirements.

Rights issues can still be classified as equity when the price is denominated in a currency other than the entity's functional currency. The price of the right is denominated in currencies other than the issuer's functional currency, when the entity is listed in more than one jurisdiction or is required to do so by law or regulation. A fixed price in a non-functional currency would normally fail the fixed number of shares for a fixed amount of cash requirement in IAS 32 to be treated as an equity instrument. As a result, it is treated as an exception in IAS 32 and therefore treated as equity.

Two measurement categories exist for financial liabilities: fair value through profit or loss (FVTPL) and amortised cost. Financial liabilities held for trading are measured at FVTPL, and all other financial liabilities are measured at amortised cost unless the fair value option is applied.

The Board and FASB have been working on a project to replace IAS 32 and converge International Financial Reporting Standards (IFRS®) and US GAAP for a number of years. The 'Financial instruments with characteristics of equity' project ('FICE') resulted in a discussion paper in 2008, but has been put on hold.

**Written by a member of the *Strategic Business Reporting* examining team**

## **Chapter 14 Cryptocurrencies**

### Executive Summary

Digital tokens are built on a distributed ledger infrastructure often referred to as a blockchain. These tokens can provide various rights. Cryptocurrency is a type of digital token, and is designed as a medium of exchange. Other digital tokens provide rights to use assets or services, or can represent ownership interests.

Cryptocurrency tokens exist conceptually as entries on a ledger (the blockchain). These 'tokens' are owned by the entity who has a key that lets it create a new entry on the ledger, which will allow the re-assignment of the ownership. These tokens are not stored on the entity's computer as the entity only stores the keys. They represent specific amounts of digital resources which the entity controls, and whose control can be reassigned to third parties.

It might appear that cryptocurrency, as it is a form of digital money, could be accounted for as cash. However, cryptocurrencies cannot be considered equivalent to cash (currency) as defined in IAS 7, *Statement of Cash Flows* and IAS 32, *Financial Instruments*:

*Presentation* as they cannot *readily* be exchanged for any good or service. Although an increasing number of entities are accepting digital currencies as payment, digital currencies are not yet widely accepted as a medium of exchange and do not represent legal tender. Entities may choose to accept digital currencies as a form of payment, but there is no requirement to do so.

IAS 7 defines cash equivalents as 'short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of changes in value'. Thus, cryptocurrencies cannot be classified as cash equivalents as they are subject to significant price volatility. Therefore, it does not appear that digital currencies represent cash or cash equivalents that can be accounted for under IAS 7.

Intuitively, it might appear that cryptocurrency should be accounted for as a financial asset at fair value through profit or loss (FVTPL). However, it does not seem to meet the definition of a financial instrument because it does not represent cash, an equity interest in an entity, or a contract establishing a right or obligation to deliver or receive cash or another financial instrument. Cryptocurrency is not a debt security, nor an equity security (although a digital asset could be in the form of an equity security) because it does not represent an ownership interest in an entity. Therefore, it appears cryptocurrency should not be accounted for as a financial asset.

Digital currencies appear to meet the definition of intangible assets. IAS 38, *Intangible Assets* defines an intangible asset as an identifiable non-monetary asset without physical substance. IAS 38 states that an asset is identifiable if it is separable or arises from contractual or other legal rights. An asset is separable if it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, identifiable asset or liability. IAS 21, *The Effects of Changes in Foreign Exchange Rates* states that the essential feature of a non-

monetary item is the absence of a right to receive (or an obligation to deliver) a fixed or determinable number of units of currency.

Thus, it appears that cryptocurrency meets the definition of an intangible asset in IAS 38 as it is capable of being separated from the holder and sold or transferred individually; and it does not give the holder a right to receive a fixed or determinable number of units of currency.

Cryptocurrency holdings can be traded on an exchange and therefore, there is an expectation that the entity will receive an inflow of economic benefits. However, cryptocurrency is subject to major variations in value and therefore it is non-monetary in nature. Cryptocurrencies are a form of digital money and do not have physical substance. Therefore, the most appropriate classification is as an intangible asset.

IAS 38 allows intangible assets to be measured at cost or revaluation. Under the cost model, intangible assets are measured at cost on initial recognition and are subsequently measured at cost less accumulated amortisation and impairment losses. Under the revaluation model, intangible assets can be carried at a revaluation amount if there is an active market for them which may not be the case for all cryptocurrencies. The same measurement model should be used for all assets in a particular asset class. If there are assets for which there is not an active market in a class of assets measured using the revaluation model, then these assets are measured using the cost model.

IAS 38 states that a revaluation increase should be recognised in other comprehensive income and accumulated in equity. However, a revaluation increase should be recognised in profit or loss to the extent that it reverses a revaluation decrease of the same asset that was previously recognised in profit or loss. A revaluation decrease is recognised in profit or loss. However, the decrease shall be recognised in other comprehensive income to the extent of any credit balance in the revaluation surplus in respect of that asset. It is unusual for intangible assets to have active markets. However cryptocurrencies are often traded on an exchange and therefore it may be possible to apply the revaluation model.

IFRS 13, *Fair Value Measurement* defines an active market, and judgement will need to be applied in determining whether an active market exists for particular cryptocurrencies. There is daily trading of Bitcoin and so it is easy to demonstrate that such a market exists. A quoted market price in an active market provides the most reliable evidence of fair value and is used without adjustment to measure fair value whenever available. In addition, the

entity will have to determine the principal or most advantageous market for the cryptocurrencies.

An entity will need to assess whether the cryptocurrency's useful life is finite or indefinite. An indefinite useful life is where there is no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. It appears that cryptocurrencies should be considered as having an indefinite life for the purposes of IAS 38. An intangible asset with an indefinite useful life is not amortised but must be tested annually for impairment.

Depending on an entity's business model, it could be appropriate to account for cryptocurrencies under IAS 2, *Inventories*. IAS 2 applies to inventories of intangible assets. IAS 2 defines inventories as assets:

- held for sale in the ordinary course of business
- in the process of production for such sale, or
- in the form of materials or supplies to be consumed in the production process or in the rendering of services.

A entity may hold cryptocurrencies for sale in the ordinary course of business and if that is the case ,then cryptocurrency could be treated as inventory. Normally, this would mean the recognition of inventories at the lower of cost and net realisable value. However, if the entity acts as a broker-trader of cryptocurrencies, then IAS 2 states that their inventories should be valued at fair value less costs to sell. This type of inventory is principally acquired with the purpose of selling in the near future and generating a profit from fluctuations in price or broker-traders' margin. Thus, this measurement method could only be applied in very narrow circumstances where the business model is to sell cryptocurrency in the near future with the purpose of generating a profit from fluctuations in price.

IAS 1, *Presentation of Financial Statements* requires an entity to disclose judgements that its management has made regarding its accounting for holdings of cryptocurrencies if those are part of the judgements that had the most significant effect on the amounts recognised in the financial statements. Also IAS 10, *Events After the Reporting Period* requires an entity to disclose any material non-adjusting events, and this would include whether changes in the fair value of cryptocurrency after the reporting period are of such significance that non-disclosure could influence the economic decisions that users of financial statements make on the basis of the financial statements.



**Chapter 15 Business combinations – IFRS 3 (Revised)**

## Executive Summary

This article provides an introduction to IFRS® 3 and IAS® 27, including piecemeal acquisitions and disposals.

## Purchase consideration

The purchase consideration includes the fair value of all interests that the acquirer may have held previously in the acquired business. This includes any interest in an associate or joint venture, or other equity interests of the acquired business. Any previous stake is seen as being 'given up' to acquire the entity, and a gain or loss is recorded on its disposal.

If the acquirer already held an interest in the acquired entity before acquisition, the standard requires the existing stake to be re-measured to fair value at the date of acquisition, taking into account any movement to the statement of profit or loss together with any gains previously recorded in equity that relate to the existing holding. If the value of the stake has increased, there will be a gain recognised in the statement of comprehensive income of the acquirer at the date of the business combination. A loss would only occur if the existing interest has a carrying amount in excess of the proportion of the fair value of the business obtained and no impairment had been recorded previously. This loss situation is not expected to occur frequently.

Contingent consideration is also recognised at fair value even if payment is not deemed to be probable at the date of the acquisition.

### EXAMPLE 1

Josey acquires 100% of the equity of Burton on 31 December 2008. There are three elements to the purchase consideration: an immediate payment of \$5m, and two further payments of \$1m if the return on capital employed (ROCE) exceeds 10% in each of the subsequent financial years ending 31 December. All indicators have suggested that this target will be met. Josey uses a discount rate of 7% in any present value calculations.

#### Requirement:

Determine the value of the investment.

#### Solution

The two payments that are conditional upon reaching the target ROCE are contingent consideration and the fair value of  $\$(1\text{m}/1.07 + 1\text{m}/1.072)$  ie \$1.81m will be added to the immediate cash payment of \$5m to give a total consideration of \$6.81m.

All subsequent changes in debt-contingent consideration are recognised in the statement of profit or loss, rather than against goodwill, as they are deemed to be a liability recognised under IAS 32/39. An increase in the liability for good performance by the subsidiary results in an expense in the statement of profit or loss, and under-performance against targets will result in a reduction in the expected payment and will be recorded as a gain in the statement of profit or loss. These changes were previously recorded against goodwill.

The nature of the contingent consideration is important as it may meet the definition of a liability or equity. If it meets the definition of equity, then there will be no re-measurement as per IAS 32/39. The new requirement is that contingent consideration is fair valued at acquisition and, unless it is equity, is subsequently re-measured through earnings rather than the historic practice of re-measuring through goodwill. This change is likely to increase the focus and attention on the opening fair value calculation and subsequent re-measurements.

The standard also requires any gain on a 'bargain purchase' (negative goodwill) to be recorded in the statement of profit or loss, as in the previous standard.

Transaction costs no longer form a part of the acquisition price; they are expensed as incurred. Transaction costs are not deemed to be part of what is paid to the seller of a business. They are also not deemed to be assets of the purchased business that should be recognised on acquisition. The standard requires entities to disclose the amount of transaction costs that have been incurred.

The standard clarifies accounting for employee share-based payments by providing additional guidance on valuation, as well as on how to decide whether share awards are part of the consideration for the business combination or are compensation for future services.

## Goodwill and non-controlling interests (NCI)

IFRS 3 gives entities the option, on an individual transaction basis, to measure NCIs (minority interests) at the fair value of their proportion of identifiable assets and liabilities, or at full fair value. The first method will result in the measurement of goodwill, a process which is basically the same as in the existing IFRS. However, the second method will record goodwill on the NCI as well as on the acquired controlling interest. Goodwill continues to be a residual but it will be a different residual under IFRS 3 (Revised) if the full

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fair value method is used as compared to the previous standard. This is partly because all of the consideration, including any previously held interest in the acquired business, is measured at fair value, but it is also because goodwill can be measured:

- as the difference between the consideration paid and the purchaser's share of identifiable net assets acquired: this is a 'partial goodwill' method because the NCI is recognised at its share of identifiable net assets and does not include any goodwill
- on a 'full goodwill' basis: this means that goodwill is recognised for the NCI in a subsidiary as well as the controlling interest.

**EXAMPLE 2**

Missile acquires a subsidiary on 1 January 2008. The fair value of the identifiable net assets of the subsidiary was \$2,170m. Missile acquired 70% of the shares of the subsidiary for \$2,145m. The NCI was fair valued at \$683m.

**Requirement:**

Compare the value of goodwill under the partial and full methods.

**Solution**

Goodwill based on the partial and full goodwill methods under IFRS 3 (Revised) would be:

Partial goodwill	\$m
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Purchase consideration	2,145
------------------------	-------

Fair value of identifiable net assets	(2,170)
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NCI (30% x 2,170)	<u>651</u>
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Partial goodwill	\$m
Goodwill	<u>626</u>
Partial goodwill	\$m

Purchase consideration	2,145
------------------------	-------

NCI	<u>683</u>
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2,828
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Fair value of identifiable net assets	<u>(2,170)</u>
---------------------------------------	----------------

Goodwill	<u>658</u>
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It can be seen that goodwill is effectively adjusted for the change in the value of the NCI, which represents the goodwill attributable to the NCI of \$32m (\$658m – \$626m). Choosing this method of accounting for NCI only makes a difference in an acquisition where less than

100% of the acquired business is purchased. The full goodwill method will increase reported net assets on the balance sheet, which means that any future impairment of goodwill will be greater. Although measuring NCI at fair value may prove difficult, goodwill impairment testing is likely to be easier under full goodwill, as there is no need to gross-up goodwill for partially owned subsidiaries.

## Fair valuing assets and liabilities

IFRS 3 (Revised) requires all of the identifiable assets and liabilities of the acquiree to be included in the consolidated statement of financial position. Most assets are recognised at fair value, with exceptions for certain items such as deferred tax and pension obligations. The International Accounting Standards Board provided additional clarity that has resulted in more intangible assets being recognised than previously. Acquirers are required to recognise brands, licences and customer relationships, and other intangible assets.

Contingent assets are not recognised, and contingent liabilities are measured at fair value. After the date of the business combination, contingent liabilities are re-measured at the higher of the original amount and the amount under the relevant standard.

The ability of an acquirer to recognise a liability for terminating or reducing the activities of the acquiree is severely restricted. A restructuring provision can be recognised in a business combination only when the acquiree has, at the acquisition date, an existing liability for which there are detailed conditions in IAS 37, but these conditions are unlikely to exist at the acquisition date in most business combinations.

An acquirer has a maximum period of 12 months from the date of acquisition to finalise the acquisition accounting. The adjustment period ends when the acquirer has gathered all the necessary information, subject to the 12-month maximum. There is no exemption from the 12-month rule for deferred tax assets or changes in the amount of contingent consideration. The revised standard will only allow adjustments against goodwill within this one-year period.

Where NCI is measured at fair value, the valuation methods used for determining that value require to be disclosed; and, in a step acquisition, disclosure is required of the fair value of any previously held equity interest in the acquiree, and the amount of gain or loss recognised in the statement of profit or loss resulting from re-measurement.

## IAS 27 Separate financial statements

This revised standard moves IFRS Standards toward the use of the economic entity approach. The economic entity approach treats all providers of equity capital as shareholders of the entity, even when they are not shareholders in the parent company.

For example, disposal of a partial interest in a subsidiary in which the parent company retains control, does not result in a gain or loss but in an increase or decrease in equity under the economic entity approach. Purchase of some or all of the NCI is treated as a treasury transaction and accounted for in equity. A partial disposal of an interest in a subsidiary in which the parent company loses control but retains an interest as an associate, creates the recognition of gain or loss on the entire interest. A gain or loss is recognised on the part that has been disposed of, and a further holding gain is recognised on the interest retained, being the difference between the fair value of the interest and the book value of the interest. The gains are recognised in the statement of comprehensive income. Amendments to IAS 28, *Investments in Associates*, and IAS 31, *Interests in Joint Ventures*, extend this treatment to associates and joint ventures.

### EXAMPLE 3

#### Step acquisition

On 1 January 2008, A acquired a 50% interest in B for \$60m. A already held a 20% interest which had been acquired for \$20m but which was valued at \$24m at 1 January 2008. The fair value of the NCI at 1 January 2008 was \$40m, and the fair value of the identifiable net assets of B was \$110m. The goodwill calculation would be as follows, using the full goodwill method:

	\$m	\$m
1 January 2008 consideration	60	

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	\$m	\$m
Fair value of interest held	24	

84

NCI	<u>40</u>
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124

Fair value of identifiable net assets	<u>(110)</u>
---------------------------------------	--------------

Goodwill 14

A gain of \$4m would be recorded on the increase in the value of the previous holding in B.

**EXAMPLE 4****Acquisition of part of an NCI**

On 1 January 2008, Rage acquired 70% of the equity interests of Pin, a public limited company. The purchase consideration comprised cash of \$360m. The fair value of the

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identifiable net assets was \$480m. The fair value of the NCI in Pin was \$210m on 1 January 2008. Rage wishes to use the full goodwill method for all acquisitions. Rage acquired a further 10% interest from the NCIs in Pin on 31 December 2008 for a cash consideration of \$85m. The carrying value of the net assets of Pin was \$535m at 31 December 2008.

	\$m	\$m
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Fair value of consideration for 70% interest	360	
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Fair value of NCI	<u>210</u>
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570

Fair value of identifiable net assets	<u>(480)</u>
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Goodwill	<u>90</u>
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**Acquisition of further interest**

The net assets of Pin have increased by  $$(535 - 480)\text{m}$  – ie \$55m and therefore the NCI has increased by 30% of \$55m – ie \$16.5m. However, Rage has purchased an additional 10% of the shares and this is treated as a treasury transaction. There is no adjustment to goodwill on the further acquisition.

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\$m

Pin NCI, 1 January 2008	210
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Share of increase in net assets in post-acquisition period	<u>16.5</u>
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Net assets, 31 December 2008	226.5
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Transfer to equity of Rage (10/30 x 226.5)	<u>(75.5)</u>
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Balance at 31 December 2008 – NCI	<u>151</u>
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Fair value of consideration	85
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Charge to NCI	<u>(75.5)</u>
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	\$m
Negative movement in equity	<u>9.5</u>

Rage has effectively purchased a further share of the NCI, with the premium paid for that share naturally being charged to equity. The situation is comparable when a parent company sells part of its holding but retains control.

### EXAMPLE 5

#### Disposal of part of holding to NCI

Using **Example 4**, instead of acquiring a further 10%, Rage disposes of a 10% interest to the NCIs in Pin on 31 December 2008 for a cash consideration of \$65m. The carrying value of the net assets of Pin is \$535m at 31 December 2008.

	\$m
Pin net assets at 1 January 2008	480
Increase in net assets	<u>55</u>
Net assets at 31 December 2008	535

	\$m
Fair value of consideration	65

Transfer to NCI (10% x (535 net assets + 90 goodwill))      (62.5)

Positive movement in equity	<u>2.5</u>
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The parent has effectively sold 10% of the carrying value of the net assets (including goodwill) of the subsidiary (\$62.5m) at 31 December 2008 for a consideration of \$65m, giving a profit of \$2.5m, which is taken to equity.

## Disposal of controlling interest while retaining associate holding

IAS 27 sets out the adjustments to be made when a parent loses control of a subsidiary:

- Derecognise the carrying amount of assets (including goodwill), liabilities and NCIs
- Recognise the fair value of consideration received
- Recognise any distribution of shares to owners
- Reclassify to profit or loss any amounts (the entire amount, not a proportion) relating to the subsidiary's assets and liabilities previously recognised in other comprehensive income, as if the assets and liabilities had been disposed of directly
- Recognise any resulting difference as a gain or loss in profit or loss attributable to the parent
- Recognise the fair value of any residual interest.

**EXAMPLE 6****Disposal of controlling interest**

On 1 January 2008, Rage acquired a 90% interest in Machine, a public limited company, for a cash consideration of \$80m. Machine's identifiable net assets had a fair value of £74m and the NCI had a fair value of \$6m. Rage uses the full goodwill method. On 31 December 2008, Grange disposed of 65% of the equity of Machine (no other investor obtained control as a result of the disposal) when its identifiable net assets were \$83m. Of the increase in net assets, \$6m had been reported in profit or loss, and \$3m had been reported in comprehensive income. The sale proceeds were \$65m, and the remaining equity interest was fair valued at \$25m. After the disposal, Machine is classified as an associate under IAS 28, *Investments in Associates*. The gain recognised in profit or loss would be as follows:

	\$m
Fair value of consideration	65
Fair value of residual interest to be recognised as an associate	25
Gain reported in comprehensive income	<u>3</u>
	93

\$m

Less net assets and goodwill derecognised:

net assets (83)

goodwill (80 + 6 – 74) (12)

Loss on disposal to profit or loss (2)

After the sale of the interest, the holding in the associate will be fair valued at \$25m.

Issues associated with both IFRS 3 and IAS 27 will be tested regularly in SBR and candidates should be comfortable with the numerical examples provided above. Candidates should also be able to provide an explanation of the principles that support these calculations.

**Written by a member of the *Strategic Business Reporting* examining team**

## **Chapter 16 Impairment of goodwill**

### Executive Summary

This article discusses and shows both ways of measuring goodwill following the acquisition of a subsidiary, and how each measurement of goodwill is subject to an impairment review.

According to IFRS® 3, *Business Combinations*, there are two ways to measure the goodwill that arises on the acquisition of a subsidiary and each has a slightly different impairment process.

This article discusses and shows both ways of measuring goodwill following the acquisition of a subsidiary, and how each measurement of goodwill is subject to an impairment review.

## How to calculate goodwill

The traditional measurement of goodwill on the acquisition of a subsidiary is the excess of the fair value of the consideration given by the parent over the parent's share of the fair value of the net assets acquired. This method can be referred to as the proportionate method. It determines only the goodwill that is attributable to the parent company.

Another method of measuring goodwill on the acquisition of the subsidiary is to compare the fair value of the whole of the subsidiary (as represented by the fair value of the consideration given by the parent and the fair value of the non controlling interest) with all of the fair value of the net assets of the subsidiary acquired. This method can be referred to as the gross or full goodwill method. It determines the goodwill that relates to the whole of the subsidiary, ie goodwill that is both attributable to the parent's interest and the non-controlling interest (NCI).

## Consider calculating goodwill

Borough acquires an 80% interest in the equity shares of High for consideration of \$500. The fair value of the net assets of High at that date is \$400. The fair value of the NCI at that date (ie the fair value of High's shares not acquired by Borough) is \$100.

### Required

- (1) Calculate the goodwill arising on the acquisition of High on a proportionate basis.
- (2) Calculate the gross goodwill arising on the acquisition of High, ie using the fair value of the NCI.

**Solution**

(1) The proportionate goodwill arising is calculated by matching the consideration that the parent has given, with the interest that the parent acquires in the net assets of the subsidiary, to give the goodwill of the subsidiary that is attributable to the parent.

Parent's cost of investment at the fair value of consideration given	\$500
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Less the parent's share of the fair value of the net assets of the subsidiary acquired	(80% x \$400)	<u>(\$320)</u>
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Goodwill attributable to the parent	\$180
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(2) The gross goodwill arising is calculated by matching the fair value of the whole business with the whole fair value of the net assets of the subsidiary to give the whole goodwill of the subsidiary, attributable to both the parent and to the NCI.

Parent's cost of investment at the fair value of consideration given	\$500
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Fair value of the NCI	\$100
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Less the fair value of the net assets of the subsidiary acquired	(100% x \$400)	<u>(\$400)</u>
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Gross goodwill	\$200
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Given a gross goodwill of \$200 and a goodwill attributable to the parent of \$180, the goodwill attributable to the NCI is the difference of \$20.

In these examples, goodwill is said to be a premium arising on acquisition. Such goodwill is positive goodwill and accounted for as an intangible asset in the group financial statements, and as we shall see be subject to an annual impairment review.

In the event that there is a bargain purchase, ie negative goodwill arises, then this is regarded as a profit and immediately recognised in income.

## Basic principles of impairment

An asset is impaired when its carrying amount exceeds the recoverable amount. The recoverable amount is, in turn, defined as the higher of the fair value less cost to sell and the value in use; where the value in use is the present value of the future cash flows.

An impairment review calculation looks like this.

*This is the carrying amount, ie the figure that the asset is currently recorded at in the financial statements.*

Impairment review

Carrying value of  
the asset

> Recoverable amount (X)



This is the estimate of how much cash the company thinks it will get from the asset, either by selling it or using it.

Impairment loss

X



This loss must be recognised, and the asset written down to the recoverable amount.

## Consider an impairment review

A company has an asset that has a carrying amount of \$800. The asset has not been revalued. The asset is subject to an impairment review. If the asset was sold then it would sell for \$610 and there would be associated selling costs of \$10. (The fair value less costs to sell of the asset is therefore \$600.) The estimate of the present value of the future cash flows to be generated by the asset if it were kept is \$750. (This is the value in use of the asset.)

### Required

Determine the outcome of the impairment review.

### Solution

An asset is impaired when its carrying amount exceeds the recoverable amount, where the recoverable amount is the higher of the fair value less costs to sell and the value in use. In

this case, with a fair value less cost to sell of only \$600 and a value in use of \$750 it both follows the rules, and makes common sense to minimise losses, that the recoverable amount will be the higher of the two, ie \$750.

### Impairment review

Carrying amount of the asset	\$800
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Carrying amount of the asset	\$800
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Recoverable amount	<u>(\$750)</u>
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Impairment loss	\$50
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The impairment loss must be recorded so that the asset is written down. There is no accounting policy or choice about this. In the event that the recoverable amount had exceeded the carrying amount then there would be no impairment loss to recognise and as there is no such thing as an impairment gain, no accounting entry would arise.

As the asset has never been revalued, the loss has to be charged to income. Impairment losses are non-cash expenses, like depreciation, so in the cash flow statement they will be added back when reconciling operating profit to cash generated from operating activities, just like depreciation again.

Assets are generally subject to an impairment review only if there are indicators of impairment. IAS® 36, *Impairment of Assets* lists examples of circumstances that would trigger an impairment review.

*External sources*

- market value declines
- negative changes in technology, markets, economy, or laws
- increases in market interest rates
- company share price is below the carrying amount

*Internal sources*

- obsolescence or physical damage
- asset is part of a restructuring or held for disposal
- worse economic performance than expected

## Goodwill and impairment

The asset of goodwill does not exist in a vacuum; rather, it arises in the group financial statements because it is not separable from the net assets of the subsidiary that have just been acquired.

The impairment review of goodwill therefore takes place at the level of a cash-generating unit, that is to say a collection of assets that together create an independent stream of cash. The cash-generating unit will normally be assumed to be the subsidiary. In this way, when conducting the impairment review, the carrying amount will be that of the net assets and the goodwill of the subsidiary compared with the recoverable amount of the subsidiary.

When looking to assign the impairment loss to particular assets within the cash generating unit, unless there is an asset that is specifically impaired, it is goodwill that is written off first, with any further balance being assigned on a pro rata basis.

The goodwill arising on the acquisition of a subsidiary is subject to an annual impairment review. This requirement ensures that the asset of goodwill is not being overstated in the group financial statements. Goodwill is a peculiar asset in that it cannot be revalued so any impairment loss will automatically be charged against income. Goodwill is not deemed to be systematically consumed or worn out thus there is no requirement for a systematic amortisation.

## Proportionate goodwill and the impairment review

When goodwill has been calculated on a proportionate basis then for the purposes of conducting the impairment review it is necessary to gross up goodwill so that in the impairment review goodwill will include an unrecognised notional goodwill attributable to the NCI.

Any impairment loss that arises is first allocated against the total of recognised and unrecognised goodwill in the normal proportions that the parent and NCI share profits and losses.

Any amounts written off against the notional goodwill will not affect the consolidated financial statements and NCI. Any amounts written off against the recognised goodwill will be attributable to the parent only, without affecting the NCI.

If the total amount of impairment loss exceeds the amount allocated against recognised and notional goodwill, the excess will be allocated against the other assets on a pro rata basis. This further loss will be shared between the parent and the NCI in the normal proportion that they share profits and losses.

## Consider an impairment review of proportionate goodwill

At the year-end, an impairment review is being conducted on a 60%-owned subsidiary. At the date of the impairment review the carrying amount of the subsidiary's net assets were \$250 and the goodwill attributable to the parent \$300 and the recoverable amount of the subsidiary \$700.

### Required

Determine the outcome of the impairment review.

### Solution

In conducting the impairment review of proportionate goodwill, it is first necessary to gross it up.

Proportionate goodwill	Grossed up	Goodwill including the notional unrecognised NCI
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$$\$300 \times 100/60 = \$500$$

Now, for the purposes of the impairment review, the goodwill of \$500 together with the net assets of \$250 form the carrying amount of the cash-generating unit.

### Impairment review

Carrying amount

Net assets                      \$250

Goodwill                      \$500

\$750

Recoverable amount      (\$700)

Carrying amount

Impairment loss                  \$50

The impairment loss does not exceed the total of the recognised and unrecognised goodwill so therefore it is only goodwill that has been impaired. The other assets are not impaired. As proportionate goodwill is only attributable to the parent, the impairment loss will not impact NCI.

Only the parent's share of the goodwill impairment loss will actually be recorded, ie  $60\% \times \$50 = \$30$ .

The impairment loss will be applied to write down the goodwill, so that the intangible asset of goodwill that will appear on the group statement of financial position will be \$270 (\$300 – \$30).

In the group statement of financial position, the accumulated profits will be reduced \$30. There is no impact on the NCI.

In the group statement of profit or loss, the impairment loss of \$30 will be charged as an extra operating expense. There is no impact on the NCI.

## Gross goodwill and the impairment review

Where goodwill has been calculated gross, then all the ingredients in the impairment review process are already consistently recorded in full. Any impairment loss (whether it relates to the gross goodwill or the other assets) will be allocated between the parent and the NCI in the normal proportion that they share profits and losses.

## Consider an impairment review of gross goodwill

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At the year-end, an impairment review is being conducted on an 80%-owned subsidiary. At the date of the impairment review the carrying amount of the net assets were \$400 and the gross goodwill \$300 (of which \$40 is attributable to the NCI) and the recoverable amount of the subsidiary \$500.

**Required**

Determine the outcome of the impairment review.

**Solution**

The impairment review of goodwill is really the impairment review of the net asset's subsidiary and its goodwill, as together they form a cash generating unit for which it is possible to ascertain a recoverable amount.

Carrying amount

Net assets                      \$400

Goodwill                      \$300

\$700

Recoverable amount      \$500

Carrying amount

Impairment loss            \$200

The impairment loss will be applied to write down the goodwill, so that the intangible asset of goodwill that will appear on the group statement of financial position, will be \$100 (\$300 – \$200).

In the equity of the group statement of financial position, the accumulated profits will be reduced by the parent's share of the impairment loss on the gross goodwill, ie \$160 (80% x \$200) and the NCI reduced by the NCI's share, ie \$40 (20% x \$200).

In the statement of profit or loss, the impairment loss of \$200 will be charged as an extra operating expense. As the impairment loss relates to the gross goodwill of the subsidiary, so it will reduce the NCI in the subsidiary's profit for the year by \$40 (20% x \$200).

## Observation

In passing, you may wish to note an apparent anomaly with regards to the accounting treatment of gross goodwill and the impairment losses attributable to the NCI. The goodwill attributable to the NCI in this example is stated as \$40. This means that goodwill is \$40 greater than it would have been if it had been measured on a proportionate basis; likewise, the NCI is also \$40 greater for having been measured at fair value at acquisition.

The split of the gross goodwill between what is attributable to the parent and what is attributable to the NCI is determined by the relative values of the NCI at acquisition to the parent's cost of investment. However, when it comes to the allocation of impairment losses attributable to the write off of goodwill then these losses are shared in the normal proportions that the parent and the NCI share profits and losses, ie in this case 80%/20%.

This explains the strange phenomena that while the NCI are attributed with only \$40 out of the \$300 of the gross goodwill, when the gross goodwill was impaired by \$200 (ie two thirds

of its value), the NCI are charged \$40 of that loss, representing all of the goodwill attributable to the NCI.

**Tom Clendon and Sally Baker are tutors at Kaplan Financial**

**Chapter 17 Additional performance measures**

## Executive Summary

For many years, regulators and standard-setters have debated how entities should best present financial performance and not mislead the user.

## Introduction

Many jurisdictions have enforced a standard format for performance reporting, with no additional analysis permitted on the face of the Statement of Profit or Loss. Others have allowed entities to adopt various methods of conveying the nature of 'underlying' or 'sustainable' earnings.

Although financial statements are prepared in accordance with applicable financial reporting standards, users are demanding more information and issuers seem willing to give users their understanding of the financial information. This information varies from the disclosure of additional key performance indicators of the business to providing more information on individual items within the financial statements. These additional performance measures (APMs) can assist users in making investment decisions, but they do have limitations.

## Common practice

It is common practice for entities to present APMs, such as normalised profit, earnings before interest and tax (EBIT) and earnings before interest, tax, depreciation and amortisation (EBITDA). These alternative profit figures can appear in various communications, including company media releases and analyst briefings. Alternative profit calculations normally exclude particular income and expense items from the profit figure reported in the financial statements. Also, there could be the exclusion of income or expenses that are considered irrelevant from the viewpoint of the impact on this year's performance or when considering the expected impact on future performance.

An example of the latter has been gains or losses from changes in the fair value of financial instruments. The exclusion of interest and tax helps to distinguish between the results of the entity's operations and the impact of financing and taxation.

These APMs can help enhance users' understanding of the company's results and can be important in assisting users in making investment decisions, as they allow them to gain a better understanding of an entity's financial statements and evaluate the entity through the eyes of the management. They can also be an important instrument for easier comparison of entities in the same sector, market or economic area.

However, they can be misleading due to bias in calculation, inconsistency in the basis of calculation from year to year, inaccurate classification of items and, as a result, a lack of transparency. Often there is little information provided on how the alternative profit figure has been calculated or how it reconciles with the profit reported in the financial statements.

The APMs are also often described in terms which are neither defined by issuers nor included in professional literature and thus cannot be easily recognised by users.

APMs include:

- all measures of financial performance not specifically defined by the applicable financial reporting framework
- all measures designed to illustrate the physical performance of the activity of an issuer's business
- all measures disclosed to fulfil other disclosure requirements included in public documents containing regulated information.

An example demonstrating the use of APMs is the financial statements of Telecom Italia Group for the year ended 31 December 2011. These contained a variety of APMs as well as the conventional financial performance measures laid down by IFRS® Standards. The non-IFRS APMs used in the Telecom Italia statements were:

**EBITDA.** Used by Telecom Italia as the financial target in its internal presentations (business plans) and in its external presentations (to analysts and investors). The entity regarded EBITDA as a useful unit of measurement for evaluating the operating performance of the group and the parent.

**Organic change in revenues, EBITDA and EBIT.** These measures express changes in revenues, EBITDA and EBIT, excluding the effects of the change in the scope of consolidation, exchange differences and non-organic components constituted by non-recurring items and other non-organic income and expenses. The organic change in revenues, EBITDA and EBIT is also used in presentations to analysts and investors.

**Net financial debt.** Telecom Italia saw net financial debt as an accurate indicator of its ability to meet its financial obligations. It is represented by gross financial debt less cash and cash equivalents and other financial assets. The report on operations includes two tables showing the amounts taken from the statement of financial position and used to calculate the net financial debt of the group and parent.

**Adjusted net financial debt.** A new measure introduced by Telecom Italia to exclude effects that are purely accounting in nature resulting from the fair value measurement of derivatives and related financial assets and liabilities.

## Evaluating the aims

The International Accounting Standards Board (IASB) is undertaking an initiative to explore how disclosures in IFRS financial reporting can be improved. The project has started to look at possible ways to address the issues arising from the use of APMs. This initiative is made up of a number of projects. It will consider such things as adding an explanation in IAS® 1 that too much detail can obscure useful information and adding more explanations, with examples, of how IAS 1 requirements are designed to shape financial statements instead of specifying precise terms that must be used. This includes whether subtotals of IFRS numbers such as EBIT and EBITDA should be acknowledged in IAS 1.

In the UK, the Financial Reporting Council supports the inclusion of APMs when users are provided with additional useful, relevant information. In contrast, the Australian Financial Reporting Council feels that such measures are outside the scope of the financial statements. In 2012, the Financial Markets Authority (FMA) in the UK issued a guidance note on disclosing APMs and other types of non-GAAP financial information, such as underlying profits, EBIT and EBITDA.

APMs appear to be used by some issuers to present a confusing or optimistic picture of their performance by removing negative aspects. There seems to be a strong demand for guidance in this area, but there needs to be a balance between providing enough flexibility, while ensuring users have the necessary information to judge the usefulness of the APMs.

To this end, the European Securities and Markets Authority (ESMA) has launched a consultation on APMs. The aim is to improve the transparency and comparability of financial information while reducing information asymmetry among the users of financial statements. ESMA also wishes to improve coherency in APM use and presentation and restore confidence in the accuracy and usefulness of financial information.

ESMA has therefore developed draft guidelines that address the concept and description of APMs, guidance for the presentation of APMs and consistency in using APMs. The main requirements are:

- Issuers should define the APM used, the basis of calculation and give it a meaningful label and context.
- APMs should be reconciled to the financial statements.
- APMs that are presented outside financial statements should be displayed with less prominence.
- An issuer should provide comparatives for APMs and the definition and calculation of the APM should be consistent over time.
- If an APM ceases to be used, the issuer should explain its removal and the reasons for the newly defined APM.

However, these guidelines may not be practicable when the cost of providing this information outweighs the benefit obtained or the information provided may not be useful to users. Issuers will most likely incur both implementation costs and ongoing costs. Most of the information required by the guidelines is already collected for internal management purposes, but may not be in the format needed to satisfy the disclosure principles.

ESMA believes that the costs will not be significant because APMs should generally not change over periods. Therefore, ongoing costs will relate almost exclusively to updating information for every reporting period. ESMA believes that the application of these guidelines will improve the understandability, relevance and comparability of APMs.

Application of the guidelines will enable users to understand the adjustments made by management to figures presented in the financial statements. ESMA believes that this information will help users to make better-grounded projections and estimates of future cashflows and assist in equity analysis and valuations. The information provided by issuers in complying with these guidelines will increase the level of disclosures, but should lead issuers to provide more qualitative information. The national competent authorities will have to implement these guidelines as part of their supervisory activities and provide a framework against which they can require issuers to provide information about APMs.

**Written by a member of the Strategic Business Reporting examining team**

## **Chapter 18 Giving investors what they need**

### Executive Summary

This article looks at how reporting capital structure is challenging, but markets are keen for the information.

## Introduction

Often the advice to investors is to focus upon cash and cash flow when analysing corporate reports. However insufficient financial capital can cause liquidity problems and sufficiency of financial capital is essential for growth. Discussion of the management of financial capital is normally linked with entities that are subject to external capital requirements but it is equally important to those entities which do not have regulatory obligations.

## What is it?

Financial capital is defined in various ways. The term has no accepted definition having been interpreted as equity held by shareholders or equity plus debt capital including finance leases. This can obviously affect the way in which 'capital' is measured which has an impact on return on capital employed (ROCE).

An understanding of what an entity views as capital and its strategy for capital management is important to all companies and not just banks and insurance companies. Users have diverse views of what is important in their analysis of capital. Some focus on historical invested capital, others on accounting capital and others on market capitalisation.

## Investor needs

Investors have specific but different needs for information about capital depending upon their approach to the valuation of a business. If the valuation approach is based upon a dividend model, then shortage of capital may have an impact upon future dividends. If ROCE is used for comparing the performance of entities, then investors need to know the nature and quantity of the historical capital employed in the business. There is diversity in practice as to what different companies see as capital and how it is managed.

There are various requirements for entities to disclose information about 'capital'. In drafting IFRS® 7, *Financial Instruments: Disclosures*, the International Accounting Standards Board (the Board) considered whether it should require disclosures about capital. In assessing the

risk profile of an entity, the management and level of an entity's capital is an important consideration.

The Board believes that disclosures about capital are useful for all entities, but they are not intended to replace disclosures required by regulators as their reasons for disclosure may differ from those of the Board. As an entity's capital does not relate solely to financial instruments, the Board has included these disclosures in IAS® 1, *Presentation of Financial Statements* rather than IFRS 7. IFRS 7 requires some specific disclosures about financial liabilities, it does not have similar requirements for equity instruments.

The Board considered whether the definition of 'capital' is different from the definition of equity in IAS 32, *Financial Instruments; Presentation*. In most cases disclosure capital would be the same as equity but it might also include or exclude some elements. The disclosure of capital is intended to give entities the ability to describe their view of the elements of capital if this is different from equity.

## IAS 1 Disclosures

As a result, IAS 1 requires an entity to disclose information that enables users to evaluate the entity's objectives, policies and processes for managing capital. This objective is obtained by disclosing qualitative and quantitative data. The former should include narrative information such as what the company manages as capital, whether there are any external capital requirements and how those requirements are incorporated into the management of capital.

Some entities regard some financial liabilities as part of capital whilst other entities regard capital as excluding some components of equity for example those arising from cash flow hedges. The Board decided not to require quantitative disclosure of externally imposed capital requirements but rather decided that there should be disclosure of whether the entity has complied with any external capital requirements and, if not, the consequences of non-compliance. Further there is no requirement to disclose the capital targets set by management and whether the entity has complied with those targets, or the consequences of any non-compliance.

## Examples

Examples of some of the disclosures made by entities include information as to how gearing is managed, how capital is managed to sustain future product development and how ratios are used to evaluate the appropriateness of its capital structure. An entity bases these disclosures on the information provided internally to key management personnel.

If the entity operates in several jurisdictions with different external capital requirements such that an aggregate disclosure of capital would not provide useful information, the entity may disclose separate information for each separate capital requirement.

Besides the requirements of IAS 1, the IFRS Practice Statement Management Commentary suggests that management should include forward-looking information in the commentary when it is aware of trends, uncertainties or other factors that could affect the entity's capital resources.

## Companies Act

Additionally, some jurisdictions refer to capital disclosures as part of their legal requirements. In the UK, Section 414 of the Companies Act 2006 deals with the contents of the Strategic Report and requires a 'balanced and comprehensive analysis' of the development and performance of the business during the period and the position of the company at the end of the period.

The section further requires that to the extent necessary for an understanding of the development, performance or position of the business, the strategic report should include an analysis using key performance indicators. It makes sense that any analysis of a company's financial position should include consideration of how much capital it has and its sufficiency for the company's needs.

The Financial Reporting Council Guidance on the Strategic Report suggests that comments should appear in the report on the entity's financing arrangements such as changes in net debt or the financing of long-term liabilities.

## Capitalisation table

In addition to the annual report, an investor may find details of the entity's capital structure where the entity is involved in a transaction, such as a sale of bonds or equities.

It is normal for an entity to produce a capitalisation table in a prospectus showing the effects of the transactions on the capital structure. The table shows the ownership and debt interests in the entity but may show potential funding sources, and the effect of any public offerings.

The capitalisation table may present the pro forma impact of events that will occur as a result of an offering such as the automatic conversion of preferred stock, the issuance of common stock, or the use of the offering proceeds for the repayment of debt or other purposes. The Board does not require such a table to be disclosed but it is often required by securities regulators.

For example, in the US, the table is used to calculate key operational metrics. Amedica Corporation announced in February 2016 that it had 'made significant advancements in its ongoing initiative toward improving its capitalisation table, capitalisation, and operational structure'.

It can be seen that information regarding an entity's capital structure is spread across several documents including the management commentary, the notes to financial statements, interim accounts and any document required by securities regulators.

## Debt and equity

Essentially there are two classes of capital reported in financial statements, namely debt and equity. However, debt and equity instruments can have different levels of benefits and risks.

When an entity issues a financial instrument, it has to determine its classification either as debt or as equity. The result of the classification can have a significant effect on the entity's reported results and financial position. Liability classification impacts upon an entity's gearing ratios and results in any payments being treated as interest and charged to earnings. Equity classification may be seen as diluting existing equity interests.

IAS 32 sets out the nature of the classification process but the standard is principle based and sometimes the outcomes are surprising to users. IAS 32 does not look to the legal form of an instrument but focuses on the contractual obligations of the instrument.

IAS 32 considers the substance of the financial instrument, applying the definitions to the instrument's contractual rights and obligations. The variety of instruments issued by entities makes this classification difficult with the application of the principles occasionally resulting in instruments that seem like equity being accounted for as liabilities. Recent developments in the types of financial instruments issued have added more complexity to capital structures with the resultant difficulties in interpretation and understanding.

The Board has undertaken a research project with the aim of improving accounting for financial instruments that have characteristics of both liabilities and equity. The Board has a major challenge in determining the best way to report the effects of recent innovations in capital structure.

## Diversity and difficulty

There is a diversity of thinking about capital, which is not surprising given the issues with defining equity, the difficulty in locating sources of information about capital and the diversity of business models in an economy.

Capital needs are very specific to the business and are influenced by many factors such as debt covenants, and preservation of debt ratings. The variety and inconsistency of capital disclosures does not help the decision making process of investors. Therefore the details underlying a company's capital structure are essential to the assessment of any potential change in an entity's financial flexibility and value.

**Written by a member of the Strategic Business Reporting examining team**

## **Chapter 19 The Integrated Report Framework**

### Executive Summary

In 2013, the International Integrated Reporting Council (IIRC) released a framework for integrated reporting. The framework establishes principles and concepts that govern the overall content of an integrated report.

In 2013, the International Integrated Reporting Council (IIRC) released a framework for integrated reporting. This followed a three-month global consultation and trials in 25 countries.

The framework establishes principles and concepts that govern the overall content of an integrated report. An integrated report sets out how the organisation's strategy, governance, performance and prospects, which lead to the creation of value. There is no benchmarking for the above matters and the report is aimed primarily at the private sector but it could be adapted for public sector and not-for-profit organisations.

The primary purpose of an integrated report is to explain to providers of financial capital how an organisation creates value over time. An integrated report benefits all stakeholders interested in a company's ability to create value, including employees, customers, suppliers, business partners, local communities, legislators, regulators and policymakers, although it is not directly aimed at all stakeholders. Providers of financial capital can have a significant effect on the capital allocation and attempting to aim the report at all stakeholders would be an impossible task and would reduce the focus and increase the length of the report. This would be contrary to the objectives of the report, which is value creation.

Historical financial statements are essential in corporate reporting, particularly for compliance purposes, but do not provide meaningful information regarding business value. Users need a more forward-looking focus without the necessity of companies providing their own forecasts and projections. Companies have recognised the benefits of showing a fuller picture of company value and a more holistic view of the organisation.

The International Integrated Reporting Framework will encourage the preparation of a report that shows their performance against strategy, explains the various capitals used and affected, and gives a longer-term view of the organisation. The integrated report is creating the next generation of the annual report as it enables stakeholders to make a more informed assessment of the organisation and its prospects.

## Principle-based framework

The IIRC has set out a principle-based framework rather than specifying a detailed disclosure and measurement standard. This enables each company to set out its own report rather than adopting a checklist approach. The culture change should enable companies to communicate their value creation better than the often boilerplate disclosures under International Financial Reporting Standards (IFRS®). The report acts as a platform to explain what creates the underlying value in the business and how management protects this value. This gives the report more business relevance rather than the compliance led approach currently used.

Integrated reporting will not replace other forms of reporting but the vision is that preparers will pull together relevant information already produced to explain the key drivers of their business's value. Information will only be included in the report where it is material to the stakeholder's assessment of the business. There were concerns that the term 'materiality' had a certain legal connotation, with the result that some entities may feel that they should include regulatory information in the integrated report. However, the IIRC concluded that the term should continue to be used in this context as it is well understood.

The integrated report aims to provide an insight into the company's resources and relationships that are known as the capitals and how the company interacts with the external environment and the capitals to create value. These capitals can be financial, manufactured, intellectual, human, social and relationship, and natural capital, but companies need not adopt these classifications. The purpose of this framework is to establish principles and content that governs the report, and to explain the fundamental concepts that underpin them. The report should be concise, reliable and complete, including all material matters, both positive and negative in a balanced way and without material error.

Integrated reporting is built around the following key components:

1. Organisational overview and the external environment under which it operates
2. Governance structure and how this supports its ability to create value
3. Business model
4. Risks and opportunities and how they are dealing with them and how they affect the company's ability to create value
5. Strategy and resource allocation
6. Performance and achievement of strategic objectives for the period and outcomes
7. Outlook and challenges facing the company and their implications

8. The basis of presentation needs to be determined, including what matters are to be included in the integrated report and how the elements are quantified or evaluated.

The framework does not require discrete sections to be compiled in the report but there should be a high level review to ensure that all relevant aspects are included. The linkage across the above content can create a key storyline and can determine the major elements of the report such that the information relevant to each company would be different.

## Relationship with stakeholders

An integrated report should provide insight into the nature and quality of the organisation's relationships with its key stakeholders, including how and to what extent the organisation understands, takes into account and responds to their needs and interests. Further, the report should be consistent over time to enable comparison with other entities.

South African organisations have been acknowledged as among the leaders in this area of corporate reporting with many listed companies and large state-owned companies having issued integrated reports. An integrated report may be prepared in response to existing compliance requirements – for example, a management commentary. Where that report is also prepared according to the framework, or even beyond the framework, it can be considered an integrated report. An integrated report may be either a standalone report or be included as a distinguishable part of another report or communication. For example, it can be included in the company's financial statements.

The IIRC considered the nature of value and value creation. These terms can include the total of all the capitals, the benefit captured by the company, the market value or cash flows of the organisation and the successful achievement of the company's objectives. However, the conclusion reached was that the framework should not define value from any one particular perspective because value depends upon the individual company's own perspective. It can be shown through movement of capital and can be defined as value created for the company or for others. An integrated report should not attempt to quantify value as assessments of value are left to those using the report.

Many respondents felt that there should be a requirement for a statement from those 'charged with governance' acknowledging their responsibility for the integrated report in order to ensure the reliability and credibility of the integrated report. Additionally, it would increase the accountability for the content of the report.

The IIRC feels the inclusion of such a statement may result in additional liability concerns, such as inconsistency with regulatory requirements in certain jurisdictions, and could lead to a higher level of legal liability. The IIRC also felt that the above issues might result in a slower take-up of the report and decided that those 'charged with governance' should, in time, be required to acknowledge their responsibility for the integrated report while, at the same time, recognising that reports in which they were not involved would lack credibility.

There has been discussion about whether the framework constitutes suitable criteria for report preparation and for assurance. The questions asked concerned measurement standards to be used for the information reported and how a preparer can ascertain the completeness of the report.

There were concerns over the ability to assess future disclosures, and recommendations were made that specific criteria should be used for measurement, the range of outcomes and the need for any confidence intervals be disclosed. The preparation of an integrated report requires judgment but there is a requirement for the report to describe its basis of preparation and presentation, including the significant frameworks and methods used to quantify or evaluate material matters. Also included is the disclosure of a summary of how the company determined the materiality limits and a description of the reporting boundaries.

The IIRC has stated that the prescription of specific KPIs and measurement methods is beyond the scope of a principles-based framework. The framework contains information on the principle-based approach and indicates that there is a need to include quantitative indicators whenever practicable and possible. Additionally, consistency of measurement methods across different reports is of paramount importance. There is outline guidance on the selection of suitable quantitative indicators.

A company should consider how to describe the disclosures without causing a significant loss of competitive advantage. The entity will consider what advantage a competitor could actually gain from information in the integrated report, and will balance this against the need for disclosure.

Companies struggle to communicate value through traditional reporting. The framework can prove an effective tool for businesses looking to shift their reporting focus from annual financial performance to long-term shareholder value creation. The framework will be attractive to companies who wish to develop their narrative reporting around the business model to explain how the business has been developed.



## **Chapter 20 Using the business model of a company to help analyse its performance\***

### Executive Summary

Understanding the business model of an entity is helpful in analysing and communicating the essence of a business, and for predicting the implications of a change in circumstance on a business.

**Understanding the business model of an entity is helpful in analysing and communicating the essence of a business and for predicting the implications of a change in circumstance on a business. Strategic Business Reporting (SBR) candidates should use this technique to improve their answers to SBR questions and this article should help them to do this.**

The business model in the context of Integrated Reporting is a company's system of 'transforming inputs, through its business activities, into outputs and outcomes that aim to fulfil the organization's strategic purposes and create value over the short, medium and long term'. The definition may seem quite theoretical but there are a number of entities who use this definition to disclose the resources (also known as capital) that the organisation draws on as inputs to its business activities, and how these are converted to outputs (products, services, by-products, and waste), which then have a further impact on the various capitals and stakeholders. The business model describes the entity's activities, asset configuration, and the way in which the business adds value including the generation of its cash flows and its customers, products and services. The aim is to provide users with insight on the ability of the business to adapt to changes, for example, in the availability, quality, and affordability of inputs, and how these changes can affect the organisation's longer-term viability.

Business model information can be fundamental to investor analysis. It provides context and understanding to the other information in the annual report. The provision of business model information can demonstrate an entity's understanding of its business and key drivers which can create investor trust and reduce risk. Additionally, investors need to understand the business, how the business has performed, and how this performance has been affected by various factors. There is an argument that the information regarding the business model should be presented outside the financial statements, such as in the management commentary. Investors will need to know how the business model is responding to market trends and how the strategy supports the key components of the business model. They will wish to know how management considers the risks and opportunities across the business model and how money is made and value generated and re-distributed. Investors will look at the Key Performance Indicators (KPIs) and how they reflect the key components of the business model. Having the business model play a role in financial reporting presumes that investors have a good understanding of it prior to assessing the entity's financial position and performance.

There has been discussion as to whether the business model should be considered in standard setting and in particular whether the term should be defined in the Conceptual Framework for Financial Reporting (the Conceptual Framework). The International

Accounting Standards Board (the Board) has decided not to define the business model in the Conceptual Framework even though there was reference to the business model in an early Exposure Draft. However, the term has been implicit in International Financial Reporting Standards (IFRS®) for a while. For example, International Accounting Standard (IAS®) 2 Inventories generally requires inventories to be measured at the lower of cost and net realisable value. However, IAS 2 includes an exception that allows commodity traders to measure their inventories at fair value less cost of sale with changes in fair value less cost to sell recognised in profit or loss. The justification for this different treatment is that the inventory of commodity traders is principally acquired with the purpose of selling in the near future and generating a profit from the fluctuation in prices.

IFRS 9 requires classification and measurement of financial assets based on an entity's business model. Although IFRS 9 does not contain a definition of the term 'business model', it does include some implicit assumptions about its meaning. IFRS 9 views the business as based upon how the entity's assets and liabilities are managed.

It states that an entity should classify financial assets as subsequently measured at either amortised cost or fair value on the basis of both:

- (a) The entity's business model for managing the financial assets and
- (b) The contractual cash flow characteristics of the financial asset.

To qualify for an amortised cost classification, the financial asset must be held to collect contractual cash flows rather than be held with a view to selling the asset to realise a profit or loss. For example, trade receivables held by a manufacturing entity are likely to fall within the 'hold to collect' business model if the trade receivables do not contain a significant financing component in accordance with IFRS 15 Revenue from Contracts with Customers.

A debt instrument is classified as subsequently measured at fair value through other comprehensive income (FVOCI) under IFRS 9 if it meets the 'hold to collect' and the 'sell' business model test. The asset is held within a business model whose objective is achieved by both holding the financial asset in order to collect contractual cash flows and selling the financial asset. This business model typically involves greater frequency and volume of sales than the hold to collect business model. Integral to this business model is an intention to sell the instrument before the investment matures.

Fair value through profit or loss (FVTPL) is the residual category in IFRS 9. If the business model is to hold the financial asset for trading, then it is classified and measured at FVTPL. Some stakeholders have suggested that the requirements for equity investments in IFRS 9 could discourage long-term investment. Their view is that the default requirement to measure those investments at fair value with value changes recognised in profit or loss may not reflect the business model of long-term investors.

The term 'business model' has also been used in other standards. IFRS 8 Operating Segments defines an operating segment as a 'component of an entity that engages in business activities from which it can earn revenue and incur expenses'. An entity with more than one business model is likely to also have different segments. If an entity has a business model, it would have internal reporting information which measure the performance of the business model which may in fact be the business segments.

IAS 40 Investment property distinguishes a property that is held by entities for investment purposes from the one that is intended to be occupied by the owner. An investment property differs from an owner-occupied property because the investment property generates cash flows largely independently of the other assets. IAS 40 sets out the two main uses of property (owner occupied and investment) which implicitly correspond to different business models. An owner-occupied property should be measured at depreciated cost less any impairment loss, which is an appropriate way of reflecting the use of the property. Whereas, investment property is measured at either fair value with fair value changes recognised in the statement of profit or loss, or on the same cost basis as for an owner-occupied property. These different accounting treatments reflect the different uses of these assets.

If the business model continues to play a significant role in standard-setting, it could give insight into how the entity's business activities are managed and help users assess the resources and liabilities of the entity. Alternatively, it can be argued that this approach may reduce comparability as it could result in different classification, measurement or disclosure of the same transaction. This may introduce bias in the way the financial statements of an entity are reported, and therefore make comparisons between entities difficult. It could encourage less neutral reporting as preparers may present the most favourable outcome which creates a conflict with faithful representation. This approach can make financial statements of entities with similar business models and in the same industry, more comparable. Thus, the difficulties with the definition of the business model and its consistent application should not constitute a reason for excluding it because it has relevance in terms of the financial decision-making needs of the users of the accounting

information. It has always been the case that different businesses will account for the same asset in different ways depending on what its role is within the firm's business model. A change in the entity's business model is a significant event, because it implies a change in how assets and liabilities are used in the cash flow generation process, that is when and how gains and losses are recognised

So, although the 'business model' concept first appeared in IFRS 9, there had been an implicit use of the concept in IFRS for a long time. The business model is not discussed in the latest Conceptual Framework and, as a result, it may be argued that there is no consistency of its use in IFRS. The United Kingdom's decision to leave the European Union highlights the unpredictability and disruptive nature of the business environment. However, it also illustrates the need for business models to be resilient and flexible to what is happening inside and outside an organisation and to help stakeholders better understand how a company will adapt to significant change. SBR candidates should be aware of these issues and be able to provide examples of these inconsistencies in an exam context.

**Written by a member of the *Strategic Business Reporting* examining team**

## **Chapter 21 Bin the clutter**

### Executive Summary

The effects of clutter have typically come in for little consideration by the preparers of annual reports. However, the phenomenon is increasingly under discussion, with initiatives recently launched to combat it.

It is unusual to think about the effects of 'clutter' but, increasingly, this phenomenon is being discussed. One prominent website describes clutter as follows: 'Clutter invades your space and takes over your life. Clutter makes you disorganised, stressed, out of control. Clutter distracts you from your priorities. Clutter can stop you achieving your goals.' This definition of clutter may not be completely applicable to annual reports, but it is possible to see certain aspects, which are applicable.

The UK's Financial Reporting Council (FRC), among other organizations, has called for reduced 'clutter' in annual reports. Additionally, the Institute of Chartered Accountants In Scotland (ICAS) and the New Zealand Institute of Chartered Accountants (NZICA) were commissioned by the International Accounting Standards Board (the Board) to make cuts to the disclosures within a certain group of International Financial Reporting Standards (IFRS®), and produce a report.

Clutter in annual reports is a problem, obscuring relevant information and making it more difficult for users to find the key points about the performance of the business and its prospects for long-term success. The main observations of the discussion paper published by the FRC were:

- there is substantial scope for segregating standing data, either to a separate section of the annual report (an appendix) or to the company's website
- immaterial disclosures are unhelpful and should not be provided
- the barriers to reducing clutter are mainly behavioural
- there should be continued debate about what materiality means from a disclosure perspective.

It is important for the efficient operation of the capital markets that annual reports do not contain unnecessary information. However, it is equally important that useful information is presented in a coherent way so that users can find what they are looking for and gain an understanding of the company's business and the opportunities, risks and constraints that it faces. A company, however, must treat all of its shareholders equally in the provision of information. It is for each shareholder to decide whether they wish to make use of that information. It is not for a company to pre-empt a shareholder's rights in this regard by withholding the information.

A significant cause of clutter in annual reports is the vast array of requirements imposed by laws, regulations and financial reporting standards. Regulators and standard setters have a key role to play in cutting clutter both by cutting the requirements that they themselves

already impose and by guarding against the imposition of unnecessary new disclosures. A listed company may have to comply with listing rules, company law, international financial reporting standards, the corporate governance codes, and if it has an overseas listing, any local requirements, such as those of the Securities and Exchange Commission (SEC) in the US. Thus, a major source of clutter is the fact that different parties require differing disclosures for the same matter. For example, an international bank in the UK may have to disclose credit risk under IFRS 7, *Financial Instruments: Disclosures*, the Companies Acts and the Disclosure and Transparency Rules, the SEC rules and Industry Guide 3, as well as the requirements of Basel II Pillar 3. A problem is that different regulators have different audiences in mind for the requirements they impose on annual reports. Regulators attempt to reach wider ranges of actual or potential users and this can lead to a loss of focus and structure in reports.

There may a need for a proportionate approach to the disclosure requirements for small and mid-cap quoted companies that take account of the needs of their investors, as distinct from those of larger companies. This may be achieved by different means. For example, a principles-based approach to disclosures in IFRS standards, specific derogations from requirements in individual IFRS standards or the creation of an appropriately adapted local version of the *IFRS for SMEs* standard. Pressures of time and cost can understandably lead to defensive reporting by smaller entities and to choosing easy options, such as repeating material from a previous year, cutting and pasting from the reports of other companies and including disclosures of marginal importance.

There are behavioural barriers to reducing clutter. It may be that the threat of criticism or litigation could be a considerable limitation on the ability to cut clutter. The threat of future litigation may outweigh any benefits to be obtained from eliminating 'catch-all' disclosures. Preparers of annual reports are likely to err on the side of caution and include more detailed disclosures than are strictly necessary to avoid challenge from auditors and regulators. Removing disclosures is perceived as creating a risk of adverse comment and regulatory challenge. Disclosure is the safest option and is therefore often the default position. Preparers and auditors may be reluctant to change from the current position unless the risk of regulatory challenge is reduced. Companies have a tendency to repeat disclosures because they were there last year.

Explanatory information may not change from year to year but it nonetheless remains necessary to an understanding of aspects of the report. There is merit in a reader of an annual report being able to find all of this information in one place. If the reader of a hard copy report has to switch to look at a website to gain a full understanding of a point in the

report, there is a risk that the report thereby becomes less accessible rather than more. Even if the standing information is kept in the same document but relegated to an appendix, that may not be the best place to facilitate a quick understanding of a point. A new reader may be disadvantaged by having to hunt in the small print for what remains key to a full understanding of the report.

Preparers wish to present balanced and sufficiently informative disclosures and may be unwilling to separate out relevant information in an arbitrary manner. The suggestion of relegating all information to a website assumes that all users of annual reports have access to the internet, which may not be the case. A single report may best serve the investor, by having one reference document rather than having the information scattered across a number of delivery points.

Shareholders are increasingly unhappy with the substantial increase in the length of reports that has occurred in recent years. This has not resulted in more or better information, but more confusion as to the reason for the disclosure. A review of companies' published accounts will show that large sections such as 'Statement of Directors Responsibilities' and 'Audit Committee report' are almost identical.

Materiality should be seen as the driving force of disclosure, as its very definition is based on whether an omission or misstatement could influence the decisions made by users of the financial statements. The assessment of what is material can be highly judgmental and can vary from user to user. A problem that seems to exist is that disclosures are being made because a disclosure checklist suggests it may need to be made, without assessing whether the disclosure is necessary in a company's particular circumstances. However, it is inherent in these checklists that they include all possible disclosures that could be material. Most users of these tools will be aware that the disclosure requirements apply only to material items, but often this is not stated explicitly for users.

One of the most important challenges is in the changing audiences. From its origins in reporting to shareholders, preparers now have to consider many other stakeholders including employees, unions, environmentalists, suppliers, customers, etc. The disclosures required to meet the needs of this wider audience have contributed to the increased volume of disclosure. The growth of previous initiatives on going concern, sustainability, risk, the business model and others that have been identified by regulators as 'key' has also expanded the annual report size.

The length of the annual report is not necessarily the problem but the way in which it is organised. The inclusion of 'immaterial' disclosures will usually make this problem worse but, in a well organised annual report, users will often be able to bypass much of the information they consider unimportant, especially if the report is on line. It is not the length of the accounting policies disclosure that is itself problematic, but the fact that new or amended policies can be obscured in a long note running over several pages. A further problem is that accounting policy disclosure is often 'boilerplate', providing little specific detail of how companies apply their general policies to particular transactions.

IFRS standards require disclosure of 'significant accounting policies'. In other words, IFRS standards do not require disclosure of insignificant or immaterial accounting policies. Omissions in financial statements are material only if they could, individually or collectively, influence the economic decisions that users make. In many cases, it would not. Of far greater importance is the disclosure of the judgments made in selecting the accounting policies, especially where a choice is available.

A reassessment of the whole model will take time and may necessitate changes to law and other requirements. For example, unnecessary clutter could be removed by not requiring the disclosure of IFRS standards in issue but not yet effective. The disclosure seems to involve listing each new standard in existence and each amendment to a standard, including separately all those included in the annual improvements project, regardless of whether there is any impact on the entity. The note becomes a list without any apparent relevance.

The Board has recently issued a request for views regarding its forward agenda in which it acknowledges that stakeholders have said that disclosure requirements are too voluminous and not always focused in the right areas. The drive by the Board has very much been to increase the use of disclosure to address comparability between companies and, in the short to medium term, a reduction in the volume of accounting disclosures does not look feasible although this is an area to be considered by the Board for its post 2012 agenda.

**Written by a member of the Strategic Business Reporting examining team**

## **Chapter 22 IAS 21 – does it need amending?\***

### Executive Summary

This article examines the issues raised by IASB research that referred to a KASB study into whether IAS 21 needs amending.

The International Accounting Standards Board (IASB) initiated a research project that examined the previous research conducted by the Korean Accounting Standards Board (KASB). This research considered whether any work on IAS 21, *The Effects of Changes in Foreign Exchange Rates*, was appropriate. This article looks at some of the issues raised by the project in the context of IAS 21®.

The foreign exchange market is affected by many factors, and in countries with a floating exchange rate, their foreign exchange rates are inevitably exposed to volatility due to the effects of the different factors influencing the market. For example, the ongoing problem of Greece repaying its enormous debts has significantly affected the value of the euro.

As the barriers to international flows of capital are further relaxed, the volatility of the foreign exchange market is likely to continue. This volatility affects entities that engage in foreign currency transactions and there has been a resultant call in some quarters to amend IAS 21.

IFRS® 7, *Financial Instruments: Disclosure* requires disclosure of market risk, which is the risk that the fair value or cashflows of a financial instrument will fluctuate due to changes in market prices. Market risk reflects, in part, currency risk. In IFRS 7, the definition of foreign currency risk relates only to financial instruments. IFRS 7 and IAS 21 have a different conceptual basis. IFRS 7 is based upon the distinction between financial/non-financial elements, whereas IAS 21 utilises the monetary/non-monetary distinction.

The financial/non-financial distinction determines whether an item is subject to foreign currency risk under IFRS 7, whereas translation in IAS 21 uses monetary/non-monetary distinction, thereby possibly causing potential conceptual confusion. Foreign currency risk is little mentioned in IAS 21 and on applying the definition in IFRS 7 to IAS 21, non-financial instruments could be interpreted as carrying no foreign currency risk. Under IAS 21, certain monetary items include executory contracts, which do not meet the definition of a financial instrument. These items would be translated at the closing rate, but as such items are not financial instruments, they could be deemed not to carry foreign currency risk under IFRS 7.

Foreign currency translation should be conceptually consistent with the conceptual framework. IAS 21 was issued in 1983 with the objective of prescribing how to include foreign currency transactions and foreign operations in the financial statements of an entity and how to translate financial statements into a presentation currency.

There is little conceptual clarification of the translation requirements in IAS 21. The requirements of IAS 21 can be divided into two main areas: the reporting of foreign currency transactions in the functional currency; and the translation to the presentation currency. Exchange differences arising from monetary items are reported in profit or loss in the period, with one exception which is that exchange differences arising on monetary items that form part of the reporting entity's net investment in a foreign operation are recognised initially in other comprehensive income, and in profit or loss on disposal of the net investment.

However, it would be useful to re-examine whether it is more appropriate to recognise a gain or loss on a monetary item in other comprehensive income instead of profit or loss in the period and to define the objective of translation. Due to the apparent lack of principles in IAS 21, difficulty could arise in determining the nature of the information to be provided on translation.

There is an argument that the current accounting standards might not reflect the true economic substance of long-term monetary assets and liabilities denominated in foreign currency because foreign exchange rates at the end of the reporting period are used to translate amounts that are to be repaid in the future. IAS 21 states that foreign currency monetary amounts should be reported using the closing rate with gains or losses recognised in profit or loss in the period in which they arise, even when the rate is abnormally high or low.

There are cases where an exchange rate change is likely to be reversed, and thus it may not be appropriate to recognise foreign exchange gains or losses of all monetary items as realised gains or losses. Thus there is an argument that consideration should be given as to whether foreign exchange gains or losses should be recognised in profit or loss or in other comprehensive income (OCI) based on the distinction between current items and non-current items.

Any potential fluctuation in profit or loss account would be reduced by recognising in OCI those foreign exchange gains or losses of non-current items with a high possibility of reversal. Furthermore, the question would arise as to whether these items recognised in OCI could be reclassified.

However, the IASB is currently determining via its conceptual framework project the purpose and nature of OCI, as there is no obvious principle that drives gains and losses out

of profit or loss and into OCI, and there is no shared view among the IASB's constituents about what should be in profit or loss and what should be in OCI.

IAS 21 does provide some guidance on non-monetary items by stating that when a gain or loss on a non-monetary item is recognised in OCI, any exchange component of that gain or loss shall be recognised in OCI.

Conversely, when a gain or loss on a non-monetary item is recognised in profit or loss, any exchange component of that gain or loss shall be recognised in profit or loss.

## Long-term liabilities

In the case of long-term liabilities, although any translation gains must be recognised in profit or loss, and treated as part of reported profit, in some jurisdictions, these gains are treated as unrealised for the purpose of computing distributable profit.

The reasoning is that there is a greater likelihood in the case of long-term liabilities that the favourable fluctuation in the exchange rate will reverse before repayment of the liability falls due.

As stated already, IAS 21 requires all foreign currency monetary amounts to be reported using the closing rate; non-monetary items carried at historical cost are reported using the exchange rate at the date of the transaction and non-monetary items carried at fair value are reported at the rate that existed when the fair values were determined. As monetary items are translated at the closing rate, although the items are not stated at fair value, the use of the closing rate does provide some fair value information. However, this principle is not applied to non-monetary items as, unless an item is measured at fair value, the recognition of a change in the exchange rate appears not to provide useful information.

A foreign operation is defined in IAS 21 as a subsidiary, associate, joint venture, or branch whose activities are based in a country or currency other than that of the reporting entity. Thus the definition of a foreign operation is quite restrictive. It is possible to conduct operations in other ways; for example, using a foreign broker. Therefore, the definition of a foreign operation needs to be based upon the substance of the relationship and not the legal form.

Although the exchange rate at the transaction date is required to be used for foreign currency transactions at initial recognition, an average exchange rate may also be used. The date of a transaction is the date on which the transaction first qualifies for recognition in accordance with IFRS. For practical reasons, a rate that approximates to the actual rate at the date of the transaction is often used. For example, an average rate for a week or a month might be used for all transactions in each foreign currency occurring during that period. However, if exchange rates fluctuate significantly, the use of the average rate for a period is inappropriate.

## Average exchange rate

A question arises as to which exchange rate to use and therefore it would be useful to have more specific guidance on the use of the average exchange rate. IAS 21 allows a certain amount of flexibility in calculating the average rate. The determination of the average rate depends upon factors such as the frequency and value of transactions, the period over which the rate will apply and the nature of the entity's systems. There are a large number of methods that can be used to calculate the average rate, but no guidance is given in IAS 21 as to how such a rate is determined.

The IASB has completed its initial assessments on this project and decided that narrow scope amendments were unnecessary. In May 2015, it had no plans to undertake any additional work and is to remove this project from the research programme, subject to feedback in the next agenda consultation.

**Written by a member of the Strategic Business Reporting examining team**

**Chapter 23 The definition and disclosure of capital**

## Executive Summary

This article is structured in two parts – first, it considers what might be included as the capital of a company and, second, why this distinction is important for the analysis of financial information.

This article is useful to those candidates studying for *Strategic Business Reporting*. It is structured in two parts: first, it considers what might be included as the capital of a company and, second, why this distinction is important for the analysis of financial information.

Essentially, there are two classes of capital reported in financial statements: debt and equity. However, debt and equity instruments can have different levels of right, benefit and risks. When an entity issues a financial instrument, it has to determine its classification either as debt or as equity. The result of the classification can have a significant effect on the entity's reported results and financial position. Liability classification impacts upon an entity's gearing ratios and results in any payments being treated as interest and charged to earnings. Equity classification may be seen as diluting existing equity interests.

IAS® 32, *Financial Instruments: Presentation* sets out the nature of the classification process but the standard is principle-based and sometimes the outcomes that result from its application are surprising to users. IAS 32 does not look to the legal form of an instrument but focuses on the contractual obligations of the instrument. IAS 32 considers the substance of the financial instrument, applying the definitions to the instrument's contractual rights and obligations.

## More complexity

The variety of instruments issued by entities makes this classification difficult with the application of the principles occasionally resulting in instruments that seem like equity being accounted for as liabilities. Recent developments in the types of financial instruments issued have added more complexity to capital structures with the resultant difficulties in interpretation and understanding. Consequently, the classification of capital is subjective which has implications for the analysis of financial statements.

To avoid this subjectivity, investors are often advised to focus upon cash and cash flow when analysing corporate reports. However, insufficient financial capital can cause liquidity problems and sufficiency of financial capital is essential for growth. Discussion of the management of financial capital is normally linked with entities that are subject to external capital requirements, but it is equally important to those entities that do not have regulatory obligations.

Financial capital is defined in various ways but has no widely accepted definition having been interpreted as equity held by shareholders or equity plus debt capital including finance

leases. This can obviously affect the way in which capital is measured, which has an impact on return on capital employed (ROCE). An understanding of what an entity views as capital and its strategy for capital management is important to all companies and not just banks and insurance companies. Users have diverse views of what is important in their analysis of capital. Some focus on historical invested capital, others on accounting capital and others on market capitalisation.

Investors have specific but different needs for information about capital depending upon their approach to the valuation of a business. If the valuation approach is based upon a dividend model, then shortage of capital may have an impact upon future dividends. If ROCE is used for comparing the performance of entities, then investors need to know the nature and quantity of the historical capital employed in the business. There is diversity in practice as to what different companies see as capital and how it is managed.

There are various requirements for entities to disclose information about 'capital'. In drafting IFRS® 7, *Financial Instruments: Disclosures*, the International Accounting Standards Board (the Board) considered whether it should require disclosures about capital. In assessing the risk profile of an entity, the management and level of an entity's capital is an important consideration. The Board believes that disclosures about capital are useful for all entities, but they are not intended to replace disclosures required by regulators as their reasons for disclosure may differ from those of the Board. As an entity's capital does not relate solely to financial instruments, the Board has included these disclosures in IAS 1, *Presentation of Financial Statements* rather than IFRS 7. IFRS 7 requires some specific disclosures about financial liabilities; it does not have similar requirements for equity instruments.

The Board considered whether the definition of capital is different from the definition of equity in IAS 32. In most cases, capital would be the same as equity but it might also include or exclude some other elements. The disclosure of capital is intended to give entities the ability to describe their view of the elements of capital if this is different from equity.

As a result, IAS 1 requires an entity to disclose information that enables users to evaluate the entity's objectives, policies and processes for managing capital. This objective is obtained by disclosing qualitative and quantitative data. The former should include narrative information such as what the company manages as capital, whether there are any external capital requirements and how those requirements are incorporated into the management of capital. Some entities regard some financial liabilities as part of capital, while other entities

regard capital as excluding some components of equity – for example, those arising from cash flow hedges.

The Board decided not to require quantitative disclosure of externally imposed capital requirements but rather decided that there should be disclosure of whether the entity has complied with any external capital requirements and, if not, the consequences of non-compliance. Further, there is no requirement to disclose the capital targets set by management and whether the entity has complied with those targets, or the consequences of any non-compliance.

Examples of some of the disclosures made by entities include information as to how gearing is managed, how capital is managed to sustain future product development and how ratios are used to evaluate the appropriateness of its capital structure. An entity bases these disclosures on the information provided internally to key management personnel. If the entity operates in several jurisdictions with different external capital requirements, such that an aggregate disclosure of capital would not provide useful information, the entity may disclose separate information for each separate capital requirement.

## Trends

Besides the requirements of IAS 1, the IFRS Practice Statement Management Commentary suggests that management should include forward-looking information in the commentary when it is aware of trends, uncertainties or other factors that could affect the entity's capital resources. Additionally, some jurisdictions refer to capital disclosures as part of their legal requirements.

In the UK, Section 414 of the Companies Act 2006 deals with the contents of the Strategic Report and requires a 'balanced and comprehensive analysis' of the development and performance of the business during the period and the position of the company at the end of the period. The section further requires that to the extent necessary for an understanding of the development, performance or position of the business, the strategic report should include an analysis using key performance indicators. It makes sense that any analysis of a company's financial position should include consideration of how much capital it has and its sufficiency for the company's needs. The Financial Reporting Council Guidance on the Strategic Report suggests that comments should appear in the report on the entity's financing arrangements such as changes in net debt or the financing of long-term liabilities.

In addition to the annual report, an investor may find details of the entity's capital structure where the entity is involved in a transaction, such as a sale of bonds or equities. It is normal for an entity to produce a capitalisation table in a prospectus showing the effects of the transactions on the capital structure. The table shows the ownership and debt interests in the entity but may show potential funding sources and the effect of any public offerings. The capitalisation table may present the pro forma impact of events that will occur as a result of an offering such as the automatic conversion of preferred stock, the issuance of common stock, or the use of the offering proceeds for the repayment of debt or other purposes.

The Board does not require such a table to be disclosed but it is often required by securities regulators. For example, in the USA, the table is used to calculate key operational metrics. America Corporation announced in February 2016 that it had 'made significant advancements in its ongoing initiative toward improving its capitalization table, capitalization, and operational structure'.

It can be seen that information regarding an entity's capital structure is spread across several documents including the management commentary, the notes to financial statements, interim accounts and any document required by securities regulators.

The Board has undertaken a research project with the aim of improving the accounting for financial instruments that have characteristics of both liabilities and equity. This is likely to be a major challenge in determining the best way to report the effects of recent innovations in capital structure.

There is a diversity of thinking about capital that is not surprising given the issues with defining equity, the difficulty in locating sources of information about capital and the diversity of business models in an economy. Capital needs are very specific to the business and are influenced by many factors, such as debt covenants and preservation of debt ratings. The variety and inconsistency of capital disclosures does not help the decision making process of investors.

Therefore, the details underlying a company's capital structure are essential to the assessment of any potential change in an entity's financial flexibility and value. An appreciation of these issues and their significance is important to candidates studying for *Strategic Business Reporting*.

**Written by a member of the Strategic Business Reporting examining team**

## **Chapter 24 The sustainable development goals**

### Executive Summary

The Sustainable Development Goals (SDGs) are 17 goals tackling major world issues agreed by 193 UN member states to be achieved by 2030. These goals include zero hunger, decent work and economic growth, and reduced inequalities.

The SDGs apply to all countries and set the priorities for governments. Demographic and social change, shifts in global economic power, urbanisation, climate change, resource scarcity, inequality and technological breakthroughs demand a corporate response. The SDGs can provide insights for companies on how they can create economic, social and environmental value for their investors and other stakeholders. The goals will allow business to understand and better respond to the risks and opportunities created by rapid change across the various sectors.

There is increasing interest by the investors in understanding how businesses are developing SDGs. Investors seek information on the relevance of the SDGs to overall strategies, and thus entities providing relevant SDG data will help investors make informed decisions which can lead to capital being channelled to responsible businesses. Companies are developing business strategies that embrace the growth potential of responsible environmental and societal policies.

There are several reasons why companies should focus on sustainable business practices, and they include:

- the increased future government focus on sustainable business
- such business practices often improve performance as they lower operational, reputational and regulatory risk
- there are significant business growth opportunities in products and services that address the SDG challenges
- the fact that short term, profit based models are reducing in relevance. Companies and their stakeholders are changing how they measure success and this is becoming more than just about profit.

Investors realise that the SDGs will not all be equally relevant to all companies, with boilerplate disclosures having little relevance at all. Good disclosure will qualitatively show how the company's SDG related activities affect the primary value drivers of the business. It would be natural to assume that SDG reporting should be based around the disclosure of information to mitigate business risk and the drive for improved predictability of investment decisions. However, if there is to be fair presentation, then there should also be disclosure of any negative and positive impacts on society and the environment.

Investors' expectations will still be focused on companies realising their core business activities with financial sustainability as a prerequisite for attracting investment. However, institutional investors have a fiduciary duty to act in the best interests of their beneficiaries,

and thus have to take into account environmental, social and governance (ESG) factors, which can be financially significant. Companies utilising more sustainable business practices provide new investment opportunities.

Investors screen companies as regards their ESG policies and integrate these factors into their valuation models. Additionally there is an increased practice of themed investing, whereby investors select a company for investment based upon specific ESG policy criteria such as clean technology, green real estate, education and health. Investors are increasingly factoring impact goals into their decision making whereby they evaluate how successful the company has been in a particular area for example, the reduction of educational inequality. This approach can help optimise financial returns and demonstrate their contribution to the SDGs through their portfolios. Investors are increasingly incentivised to promote sustainable economies and markets to improve their long-term financial performance.

Institutional investors realise that environmental events can create costs for their portfolio in the form of insurance premiums, taxes, and the physical cost related with disasters. Social issues can lead to unrest and instability, which carries business risks which may reduce future cash flows and financial returns.

Investors seek SDG information produced in line with widely-accepted recommendations. The Global Reporting Initiative (GRI) and the UN Global Compact amongst others, have developed guidance documents that mutually complement each other and create a reference point for companies.

Companies should disclose to investors how they have decided on their SDG strategy, philosophy and approach. The approach should be capable of measurable impacts and have a clear description of the material issues and a narrative that links the sustainability issues back to the business model and future outlook of the entity.

For investors, it is important that SDG-related reporting is presented in the context of the strategy, governance, performance and prospects of the entity. Stakeholders should be engaged from the beginning in order to identify any potential impact with some investors expecting companies to have a stakeholder dialogue that goes beyond financial matters. Investors often require an understanding of how the entity feels about the relevance of the SDGs to the overall corporate strategy, and this will include a discussion of any risks and opportunities identified and changes that have occurred in the business model as a result.

The SDGs and targets are likely to present some of the greatest business risks and opportunities for companies who should publish material SDG contributions, both positive and negative, as part of their report. For example, an inability to address negative social and environmental impacts may also be directly detrimental to short-term financial value for a business. Investors are increasingly seeking investment opportunities that can make a credible contribution to the realisation of the SDGs.

However, if an investor wants to have a positive impact on working conditions for example, they cannot assume that any investment in this area is relevant. The investor would need to be provided with additional information such as data on the lowest income workers, any potential income increase and how confident the company is that an increase in income will occur.

Investors can choose not to invest in, or to favour, certain investments. Alternatively, they can actively engage in new or previously overlooked opportunities that offer an attractive impact and financial opportunity, even though these may involve additional risk.

There is an assumption that the disclosure of ESG factors will ultimately affect the cost of capital; lowering it for sustainable businesses and increasing it for non-sustainable ones. It may also affect cash flow forecasts, business valuations and growth rates. Investors employ screening strategies, which may involve eliminating companies that have specific features, for example, low pay rates for employees and eliminating them on a ranking basis. They may also be eliminated on the basis of companies who are contributing or not, to a range of SDGs and targets. Investors will use SDG-related disclosures to identify risks and opportunities on which they will, or will not, engage with companies. Investors will see potential business opportunities in those companies that address the risks to people and the environment and those companies that develop new beneficial products, services and investments that may mitigate the business risks related to the SDGs.

**Written by a member of the *Strategic Business Reporting* examining team**