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International Financial Reporting Standards



Understanding IFRSs

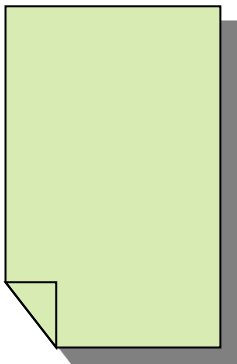
A Framework-based approach

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The views expressed in this presentation are those of the presenter,
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Framework-based understanding...

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



Concept



Principles



Rules

Does the *Framework* help me understand IFRSs?

- Yes, the starting point for understanding all IFRS information is the objective and the concepts that flow logically from that objective:
 - IASB uses *Framework* to set IFRSs
 - Teachers/Trainers use *Framework*-based teaching to prepare students to make judgements that are necessary to apply IFRSs
 - Preparers use *Framework* to make the judgements that are necessary to apply IFRSs
 - Auditors and regulators assess those judgements
 - Investors, lenders and others consider those judgements when using IFRS financial information to inform their decisions

The IASB's *Conceptual Framework*

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

Other concepts all flow from the objective

Objective of financial reporting

“Provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.”

Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans or other forms of credit

Objective of financial reporting

- Primary users
 - provide resources, but cannot demand information
 - common information needs
- Assess the prospects for future net cash inflows
 - buy, sell, hold
 - efficient and effective use of resources

Fundamental qualitative characteristics

- Relevance
 - predictive value
 - confirmatory value
 - materiality, entity-specific
- Faithful representation (replaces reliability)
 - completeness
 - neutrality
 - free from error

Enhancing qualitative characteristics

- Comparability
- Verifiability
- Timeliness
- Understandability

Examples 1a, b and c: errors and changes in policies and estimates

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- Objective
- Concepts including qualitative characteristics
 - faithful representation
 - comparability
- Principle
 - **1a Prior period error:** retrospective restatement
 - **1b Change in policy:** retrospective application
 - **1c Change in estimate:** prospective application
- Rules
 - impracticable exception

- Cost
 - IASB assesses whether the benefits of reporting particular information are likely to justify the costs incurred to provide and use that information.

Note: It **is consistent** with the *Framework* for an IFRS requirement not to maximise the qualitative characteristics of financial information and other main Framework concepts when the costs of doing so would **exceed the benefits.**

Example 2: Transitional provisions new or amended IFRSs

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- The **concepts** = objective and qualitative characteristics, particularly comparability
- The **principle** = retrospective application of new accounting policy
- The **rule** = transitional provisions for new and amended IFRSs
 - application of the cost constraint

Asset

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

Liability

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

Equity = assets less liabilities

Income

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

Expense

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

The concepts

- Information about the nature and amounts of an entity's economic resources and claims against the reporting entity help users identify the reporting entity's financial strengths and weaknesses (see ¶OB12–OB14).
 - help assess entity's prospects for future cash flows, its liquidity and solvency, its needs for additional financing and how successful it is likely to be in obtaining financing.
- Definition of asset, liability and equity (¶4.4)

Examples 3a, b and c

Financial position, which element?

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Question: asset, liability or equity at 31/12/20X1?

- **3a** on 01/01/20X2 an entity declared a final dividend for the year ended 31/12/20X1.
- **3b** due to extraordinarily high snowfall in 20X1 a snow ski operator received higher than average revenue for 20X1. Management wants to recognise a liability (and expense in 20X1) for the effects of expected future warmer years.
- **3c** non-controlling shareholders own 25% of the equity of a subsidiary.

Financial performance

The concepts

- Financial performance during a period, reflected by changes in its economic resources and claims (other than by obtaining additional resources directly from investors and creditors), is useful in assessing the entity's past and future ability to generate net cash inflows (see ¶OB18)
- Accrual basis of accounting (depicts the effects of transactions and other events and circumstances on a reporting entity's economic resources and claims **in the periods in which those effects occur** (see ¶OB17))

Example 4

Biological asset in agricultural activity

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- The **concepts**: see the previous slide
- The **principle**: A gain or loss arising on initial recognition of a biological asset at fair value less costs to sell and from a change in fair value less costs to sell of a biological asset shall be included in profit or loss for the period (IAS 41.26)
- The limited **exception**: inability at initial recognition to measure fair value reliably then cost-depreciation-impairment model (IAS 41.27)

Example 5

Allocating depreciation: **concepts**

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

– land with an indefinite useful life is not depreciated

because its service potential does not reduce with time

Example 5

Allocating depreciation: **principle**

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- Depreciation is the **systematic allocation** of the **depreciable amount** of an asset over its **useful life** (IAS16.6)
 - essentially a cost allocation technique (IAS16.BC29)

Example 5: allocating depreciation: application guidance (1)

- Systematic allocation (application guidance):
 - **Depreciation method** must closely reflect the pattern in which the asset's future economic benefits are expected to be consumed by the entity.
 - **Unit of measure** for depreciation is different from that for an item of PPE. By depreciating significant parts of an item of PPE separately, depreciation more faithfully represents the consumption of the assets service potential.

Example 5: allocating depreciation: application guidance (2)

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

Example 5: allocating depreciation: application guidance (3)

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

- The **concept**: recognise element (eg asset) when
 - **probable** that benefits will flow to/from the entity
 - has cost or value that can measured reliably (see ¶4.38)
- The **principle**
 - recognise elements (eg asset) when they satisfy the definition and recognition criteria (see ¶ IAS1.28)
- Applying the principle (see individual IFRSs)

- Measurement is the process of determining monetary amounts at which elements are recognised and carried. (¶4.54)
- To a large extent, financial reports are based on estimates, judgements and models rather than exact depictions. The *Framework* establishes the concepts that underlie those estimates, judgements and models (¶OB11)
- IASB guided by **objective** and **qualitative characteristics** when specifying measurements.

- Measurement section of *Framework* is weak—only lists some measurement methods used in practice:
 - historical cost: cash paid or fair value of consideration given
 - current cost: cash that would be paid if acquired now
 - realisable (settlement) value: cash that could be obtained by selling the asset now
 - present value: present discounted value of future net cash inflows that the item is expected to

generate

market value: listed but not described in

- Derecognition of an asset refers to when an asset previously recognised by an entity is removed from the entity's statement of financial position
 - derecognition requirements are specified at the **standards level**.
 - derecognition does not necessarily occur when the asset no longer satisfies the conditions specified for its initial recognition (ie derecognition does not necessarily coincide with the loss of control of the asset)

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

Framework-based understanding provides...

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

- a basis for **continuously updating** IFRS

knowledge and IFRS competencies

Does the *Framework* help me apply IFRSs?

- Yes, Framework is in IAS 8 hierarchy (see next slide)
 - Preparers use the *Framework* to make the judgements that are necessary to apply IFRSs
 - Auditors and regulators assess those judgements
 - Investors, lenders and others consider those judgements when using IFRS financial information to inform their decisions

- **Use judgement** to
 - develop a policy that results in **relevant** information that **faithfully represents** (ie complete, neutral and error free)
 - Hierarchy:
 - 1st IFRS dealing with similar and related issue
 - 2nd *Framework* definitions, recognition crit. etc
 - Can also in parallel refer to GAAPs with **similar Framework**

In other words, if no IFRS requirement ³¹.

Framework-based approach would ask:

- What is the economics of the phenomenon (eg transaction or event)?
- What relevant information using the accrual basis of accounting faithfully present that economic phenomenon to inform decisions of investors and lenders (potential and existing)?
- Is there anything in IFRSs that prevents me from providing that information?

Example 6: non-cash distribution

Before IFRIC 17, entity distributes non-cash asset (eg land or shares in another) whose fair value = CU1 mill. Carrying amount of asset = cost = CU1K

- Economics = reduce owners' claims against the entity by distributing to them an asset worth CU1 million.
- Relevant information for investors and lenders that faithfully represents the economics:
 - investors received CU1 million refund of capital.
 - value of assets available to meet lenders' claims reduced by CU1 million.

Example 6: non-cash distribution

Before IFRIC 17... (continued)

- Does IFRSs prevent providing that information? No. Therefore:
 - recognise CU999K income (previously unrecognised increase in the value of the asset derecognised).
 - recognise CU1 million distribution to owners.

Example 7: share-based payment


Before IFRS 2, entity pays employee in own shares. Par value of shares issued = CU1K. Fair value of services provided = CU1 million = fair value of shares.

- Economics = entity paid employees CU1 million for services. Employees invested CU1 million in entity.
- Relevant information for investors and lenders that faithfully represents the economics:
 - CU1 million services received = staff cost.
 - CU1 million invested = increased owner equity.
- Does IFRSs prevent providing that information?

No. Therefore, recognise CU1 million expense IFRS

and recognise CU1 million increase in owners'

Common misunderstandings

The <i>Framework</i> does not...	Clarification—the <i>Framework</i> includes
include a matching concept	accrual basis of accounting—recognise elements when satisfy definition and recognition criteria
include prudence/conservatism concept	neutrality concept
include an element other comprehensive income (or a concept for OCI)	only the following elements—asset, liability, equity, income and expense
mention management intent or business model	

Common misunderstandings continued

Misunderstanding	Clarification
Principles are necessarily less rigorous than rules	Rules are the tools of financial engineers
There are few judgements and estimates in cost-based measurements	Inventory, eg allocate joint costs and production overheads PP&E, eg costs to dismantle/restore site, useful life, residual value, depreciation method Provisions, eg uncertain timing and amount of expected future cash flows

Support for *Framework*-based teaching 37

- IFRS Foundation education initiative works with others to support *Framework*-based teaching
 - create awareness
 - develop material (starting with PPE)
 - hold workshops (in 2011: Basseterre and Vienna with World Bank; Bucharest, Denver, George and Venice with IAAER; and Rio with BNDES)
 - encourage those certifying accountants to examine their students' ability to make the

Questions or comments?

Expressions of individual views by members of the IASB and their staff are encouraged.

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