

# IFRS Foundation: Special Interest Sessions

Morning of Monday 23 June 2014—Lancaster hotel in London, UK

## *Cross-cutting measurement issues*

To enhance understanding of cross-cutting IFRS measurement issues, the IFRS Foundation will hold an intensive half-day session immediately before the IFRS conference, on the morning of 23 June 2014.

09:00 ***Registration and refreshments***

09:30 ***Introduction***  
**Gary Kabureck**  
*Member*  
**IASB**

09:35 ***IFRS measurements: an overview***  
**Hugh Shields**  
*Executive Technical Director*  
**IASB**

10:00 ***Panel discussion: cross-cutting issues***  
*Chair: Gary Kabureck, Member, IASB*

*Panellists include:*

- Financial instrument advisor: **Chris Spall**, *Global IFRS Financial Instruments Leader, KPMG*
- IASB member: **Patrick Finnegan**
- Non-financial asset valuation expert: **Jochem Quaak**, *Managing Director, Duff & Phelps*

11:55 ***Concluding comments***  
**Gary Kabureck**  
*Member*  
**IASB**

12:00 ***Close session***



**IFRS Foundation**  
**IFRS Conference**  
Monday 23 and Tuesday 24 June 2014  
Lancaster Hotel, London

**Special Interest Session**

**Cross-cutting measurement issues**

**GARY KABURECK**

*Member*

**IASB**

**HUGH SHIELDS**

*Executive Technical Director*

**IASB**

**CHRIS SPALL**

*Global IFRS Financial Instruments Leader*

**KPMG**

**PATRICK FINNEGAN**

*Member*

**KPMG**

**JOCHEM QUAACK**

*Managing Director*

**Duff & Phelps**





## IFRS measurements: an overview

London, June 2014

The views expressed in this presentation are those of the presenter,  
not necessarily those of the IASB or IFRS Foundation.

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## Objective of IFRS financial reporting

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Provide financial information about the reporting entity that is useful to **existing and potential investors, lenders and other creditors** in making decisions about providing resources to the entity (buy, sell, hold, provide loan/settle (OB 2))  
...who cannot require reporting entities to provide information directly to them (OB 5)  
...who have a reasonable knowledge of business and economic activities and who review and analyse the information diligently (QC 32)

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## Objective of IFRS financial reporting

continued

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

## Objective of IFRS financial reporting

continued

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

## Qualitative characteristics

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

## Fundamental qualitative characteristics

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

## Enhancing qualitative characteristics

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

## Cost constraint

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



## Measurement concepts?

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- Conceptual Framework
  - none—a list of measurement conventions (¶4.54–4.56)
- Conceptual Framework Discussion Paper (2013)
  - for a particular asset should depend on how that asset contributes to future cash flows; and
  - for a particular liability should depend on how the entity will settle or fulfil that liability. (¶6.35(d))
  - the number of different measurements used should be the smallest number necessary to provide relevant information. (¶6.35(e))

## How many IFRS measurements? *assets*

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

## Unmodified historical cost? *the 'concept' ¶4.55(a)*

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The unmodified historical cost of an asset is:

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

## Unmodified historical cost? *example 1*

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Today you receive (and gain control of) a new aircraft in exchange for:

- cash 100; and
- landing right (HC = 50; DHC = 40; FV = 60); and
- mandatory transferable deposit/'option' to acquire aircraft (HC = 1; FV = 10).

*What is the cost of the aircraft?—choose 1 of:*

*(1) 100; (2) 141; (3) 151; (4) 161; (5) 170*

## Unmodified historical cost? *example 2*

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Today a machine manufacturer offers to sell you a machine in exchange for:

- 121 cash today when you take the machine;
- 146.41 two years later; take the machine today; or
- 100 cash today; take the machine two years later (on delivery 2 years later FV of machine = 170).

*What is the cost of the machine?—choose 1 of:  
(1) 100; (2) 121; (3) 146.41; (4) 170*

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## Unmodified historical cost? *example 3*

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100 years ago your great-grandfather acquired a flock of 1,000 sheep in exchange for CU1,000.

Today your family's first 100<sup>th</sup> generation lamb is born.

*What is the cost of the 100<sup>th</sup> generation lamb?*

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## Fair value of an asset the concept (IFRS 13)

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- Fair value is the price that would be received to sell an asset in an orderly transaction (*not a forced sale*) between market participants (*market-based view*) at the measurement date (*current price*).
- Fair value is a market-based measurement (it is not an entity-specific measurement)
  - the entity's intention is not relevant
  - highest and best use principle 'reflects' value maximisation (highlighting opportunity costs)

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## Fair value measurement example of regulatory ruling

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

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

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

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

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## Fair value example 1

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For generations your family farms avocados in Balito. Today:

- the fair value of the farmland with fruit bearing trees = 100
- if vacant, the fair value of the farmland would also be 100
- the present value of the risk adjusted expected net cash flows from harvesting fruit from your existing avocado trees = 30. However, if you rented the land at market rate would = nil.

What is the fair value of the fruit bearing trees?

Choose 1 of: (a)100; (b)30; (c)23 (d)0; (e) another amount

Scenario 1: you farm using rented land; Scenario 2: you revalue land; Scenario 3: you do not revalue land.

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## Which model better enables primary users to project future cash flows?

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**Example 1:** In Y0 you construct a car manufacturing plant for 1,000,000 in Country A (A). In Y1 vast quantities of oil are unexpectedly discovered in A, the improved economic outlook for A quadruples the market value of your plant. Eager to participate in the boom market your competitors build their plants in A from Y1 onwards. Each car you build costs 100 cost model or 300 revaluation model.

The cost of your competitors' cars = 300

*You sell cars at 250 each. What multiple should primary users apply to the margin from the sale of your cars? Put another way, for each car sold economically are you 'making' (choose 1 of):*

*(1) 150 profit; or (2) 50 loss; or (3) it depends—(4) if cost model and (5) if revaluation model*

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## Which model better enables primary users to project future cash flows?

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**Example 2:** In Y0 you purchase a new purpose built parkade in exchange for 900,000 today **plus** only if one million or more cars use the parkade by the end of Y1 you will pay a further 200,000.

At the time of purchase you assess 50/50 probability to the contingent payment. The contingency is met and paid in Q4 Y1.

Ignore the time value of money. Assume the acquisition is **not** a business combination.

*Does the change in the probability reflect in the cost of the parkade or in the performance of the parkade?*

*In other words, is the cost of the parkade (choose 1 of):*

*(a) 900,000 (b) 1,000,000 (c) 1,100,000*

## Does seeing the big picture help answer some vexing questions?

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For each example below, choose either (1) reflects the economic reality; or (2) is nonsensical?

- **Ex 1**—financial liabilities: own credit risk downgrade results in recognising income (IFRS 9 solution = recognise change in OCI)
- **Ex 2**—being granted certificates in a cap and trade emission trading scheme = income
- **Ex 3**—equity decreases when controlling interest pays market price to buy out minority interests

Put another way, is it 'shortcomings' in recognition and measurement requirements for assets and liabilities that results in 'counterintuitive' knock-on effects for the reporting of subsequent transactions or events?

Thank you

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