Presentation Materials

Conceptual Framework CPE Session #11

The Conceptual Framework—Framework-based Teaching workshop and IASB project update

13:00 to 17:30 Saturday 3 August 2013

Anaheim, US

IFRS™

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Programme

13:00 ***Introduction to Framework-based Teaching (FBT)***
Michael (Mike) Wells, Director, IFRS Education Initiative, IASB

13:30 ***Demonstrating FBT for CPA stream students***
Mike Wells, Director, IFRS Education Initiative, IASB

14:15 Comfort break

14:45 ***IASB project to improve the Conceptual Framework***
Ronald (Ron) Lott, FASB staff seconded to the IASB's Conceptual Framework project

15:45 ***Q&A and discussion***

Mike Wells

Ron Lott

16:30 ***Demonstrating FBT for MBA students***
Alan Jagolinzer, *Associate Professor of Accounting Director, Ph.D. Program in Accounting,* University of Colorado

17:10 ***Q&A and discussion***

Alan Jagolinzer

17:30 Close

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Introduction to Framework-based Teaching (FBT)

Michael Wells
Director, IFRS Education Initiative
IASB

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Demonstrating FBT for CPA stream students

Michael Wells
Director, IFRS Education Initiative
IASB

Amalgam case study

Michael J C Wells, Director, IFRS Education Initiative, IASB

Robert P Garnett, Professor of Accounting, University of the Witwatersrand

This case study is currently 'work in process'. It will be revised following comments from people attending a series of workshops on the Framework-based approach to teaching International Financial Reporting Standards (IFRS) organised by the IFRS Foundation and others (including the American Accounting Association (AAA), the European Accounting Association (EAA), the Southern African Accounting Association (SAAA) and the International Association for Accounting Education and Research (IAAER)). After revisions, the material will be available as an educational resource on the IFRS website.

Background

Amalgam[1] has been listed on the Afriganistan Stock Exchange for more than ten years. It was founded by Mrs Conglomerate (Mrs C) and Mrs C holds the controlling equity interest. Amalgam's functional currency is the US dollar ($).

For many years Mr Judgement (Mr J) has led the financial reporting team at Amalgam. Last year, Amalgam's financial statements were prepared in accordance with IFRS for the first time. Previously, the financial reporting requirements applied were mostly tax-based. Mr J found that he needed to exercise a greater amount of judgement and make many more estimates in order to apply IFRS.

In the current reporting period (20X2) Amalgam entered into a number of transactions for which Mr J cannot find specific IFRS requirements. Mr J wonders how, in the absence of explicit IFRS requirements, he should account for and report those transactions in Amalgam's financial statements for the year ended 31 December 20X2. Consequently, he seeks your expert opinion on how to account for the following transactions in accordance with IFRS.

Reorganisation

On 31 December 20X2 Amalgam acquires all of the equity of Ation from Conglomerate, in exchange for $20,000 million in cash. Mrs C owns all of the equity of Conglomerate and controls both Conglomerate and Amalgam.

[1] The names of individuals, entities and places in this case study are fictitious. Any resemblance to actual people, entities or places is purely coincidental.

Summary financial information for Amalgam and Ation on 31 December 20X2 (immediately before the transaction above) is as follows:

	Amalgam		Ation	
	Carrying amount	*Fair value*	*Carrying amount*	*Fair value*
	$'millions	*$'millions*	*$'millions*	*$'millions*
Identifiable assets	300,000	600,000	35,000	50,000
Liabilities	(200,000)	(190,000)	(32,000)	(29,000)
Contingent liabilities	–	(10,000)	–	(3,000)
	100,000	**400,000**	**3,000**	**18,000**

Gold acquired and held as a 'store of wealth'

On 30 June 20X2 Amalgam acquires 1,000,000 ounces of gold at $1,000 per ounce and stores it in a secure vault at the local branch of an international bank. Amalgam neither trades in gold nor does it have any use for the gold, other than as a 'store of wealth'. Amalgam's 'risk management' team expect to hold the gold for the foreseeable future and the cash used to pay for the gold is surplus to the entity's foreseeable cash flow needs.

At 31 December 20X2 (the end of the current annual reporting period), gold is trading at $1,500 per ounce and Amalgam continues to hold 1,000,000 ounces of gold as a store of wealth.

Artwork collection

In September 20X2, Amalgam begins collecting artworks for the first time. It acquires 10 paintings at auctions in London, Hong Kong and New York at a total cost of $1,000 million.

Amalgam neither trades in artworks nor does it intend to do so in the future. However, in managing the art collection, it is envisaged that some artworks might need to be sold to fund the acquisition of other, more desirable, pieces.

The artwork collection is stored in a purpose-built underground vault at Amalgam's head office building. On occasion, Amalgam might invite its most important customers and other special guests to view the collection at no charge.

Amalgam’s ‘risk management’ team expect to hold the art indefinitely and the cash used to pay for the collection is surplus to the entity’s foreseeable cash flow needs.

In October 20X2 Mrs Artlover (Mrs A) died. In her will she bequeathed $2,000 million to Amalgam on the condition that Amalgam uses the cash exclusively to expand its artwork collection before the end of 20X4. This bequest was received as cash in November 20X2. Any bequeathed cash not invested in artworks at the end of 20X4 will revert to the estate for distribution to Mrs A’s children. By 31 December 20X2 Amalgam had already invested $500 million of the cash received in artworks.

Some IFRS issues for class discussion
In the absence of an IFRS that specifically applies to a transaction or other event, how does an entity develop an accounting policy for that transaction or other event?
How would you advise Mr J when he is developing an accounting policy for the acquisition of Ation in Amalgam’s consolidated financial statements?
How would you advise Mr J when he is developing an accounting policy for Amalgam to account for the gold held as a store of wealth?
How would you advise Mr J when he is developing an accounting policy for Amalgam to account for the artworks held as a store of wealth?
How would you advise Mr J when he is developing an accounting policy for the $2,000 million in cash received from Mrs A’s estate?

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Ronald Lott

FASB Seconded to the IASB's Conceptual Framework project

International Financial Reporting Standards

Conceptual Framework
3 August 2013

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

IFRS

Session overview

- Why?
- Where are we?
- High level overview of proposals
  - Measurement
  - Presentation & disclosure (including OCI)
  - Elements, recognition, and liabilities/equity
- Questions

IFRS

Why?

- Agenda consultation
- Purpose of project
  - Update, improve and fill in gaps
  - Focus on standard-setting problems

IFRS

Where are we?

- Objective
- Qualitative characteristics

Completed

ED (2010)

- Reporting entity

- Everything else

Now

IFRS

Objective of financial reporting

To provide useful financial information
To existing & potential investors, lenders and other creditors
Decisions about providing resources to the entity

Resources of the entity Claims against the entity Changes to them	Effectiveness and efficiency in management of resources

IFRS

Qualitative characteristics

- Relevance
- Faithful representation

Useful

Fundamental qualitative characteristics

Enhancing characteristics

- Comparability
- Understandability
- Verifiability
- Timeliness

IFRS

Discussion Paper

- Issued July 2013
- Comments requested — 14 January 2014
- Subject matter
  - **Elements of financial statements**
  - Additional guidance on assets and liabilities
  - Recognition and derecognition
  - **Equity and distinction between equity and liabilities**
  - **Measurement**
  - Presentation and disclosure
  - **Profit and loss and OCI**
  - Other issues

IFRS

Existing definitions

Asset [of an entity]	Liability [of an entity]
• a **resource** controlled by the entity	• a **present obligation** of the entity
• as a result of **past events**	• arising from **past events**
• from which **future economic benefits** are **expected** to flow to the entity	• the settlement of which is **expected** to result in an outflow from the entity of resources embodying **economic benefits**

IFRS

Problems with existing definitions and recognition

- Risk of confusing:
  - Resource or obligation
  - Inflows or outflows that may result
- What does *expected* mean and how does it relate to *probable* in the recognition criteria?
- More guidance needed?
  - What is a resource?
  - What is an obligation?

IFRS

Possible revised definitions

Clarify definitions

Asset [of an entity]	Liability [of an entity]
• A **present economic resource** controlled by the entity as a result of **past events**	• a **present obligation** of the entity to transfer an **economic resource** as a result of **past events**
• An economic resource = a right, or other source of value, that is **capable** of producing economic benefits	

IFRS

Summary of further guidance proposed

- To support asset definition
  - define *economic resource*
  - define *controlled*
- To support liability definition
  - constructive obligations
  - future events
- To support both definitions
  - *substance* of contractual rights and obligations
  - executory contracts

IFRS

Recognition & derecognition

- Recognition
  - Recognise items that meet definitions of elements, unless results do not provide useful information (relevant, faithful representation) or costs exceed benefits
- Derecognition:
  - Not addressed in the existing *Framework*
  - Mirror image of recognition, but may need to consider:
    - Enhanced disclosure, or presentation on a separate line
    - Continued recognition

IFRS

Liability vs Equity

- Existing definition of equity: residual interest in assets after deducting liabilities
- Problems with IAS 32 definition of financial liabilities
  - conflicts with the framework
  - Complex, difficult to understand and difficult to apply consistently
- Possible approach
  - Use conceptual definition of a liability:
    - obligation to transfer economic resources
  - Use expanded statement of changes in equity:
    - wealth transfers between equity holders

IFRS

Example: Changes in Equity

	Existing shareholders of parent		Non-controlling interests (NCI)	Obligation to issue shares	Total
	Share capital	Retained earnings			
Opening 1 January 20X2	10,000	20,000	4,000	-	34,000
Written option issued	-	-	-	5,000	5,000
Total profit/ comprehensive income for X2	-	3,500	200	-	3,700
Change in fair value of written option	-	1,000	-	-1,000	-
31 December 20X2	10,000	24,500	4,200	4,000	42,700

IFRS

Measurement

The objective of measurement is to faithfully represent relevant information about
- Resources of the entity
- Claims against the entity,
- Changes to those resources and claims
- How efficiently and effectively management has used the resources.

A single measurement basis may not provide the most relevant information

Number of different measurements used should be smallest number necessary

IFRS

Measurement (2)

Consider information produced in both:
- the statement of financial position (SFP); and
- the statement(s) of profit or loss and other comprehensive income (OCI)

Most relevant measure depends on:
- How an asset contributes to future cash flows
- How the entity will fulfil or settle a liability

Consider cost-benefit

IFRS

Presentation & disclosures: Current problems

Not currently addressed

Presentation
How to present performance?
- Profit or loss
- OCI

Disclosures
Poorly targeted
- *Conceptual Framework* project
- Disclosure initiatives

IFRS

Presentation & disclosure

Clarify purpose of primary financial statements & notes
- Information about the existing resources, claims against the entity, and changes to those resources and claims

Introduce principles for presentation
- Classification, aggregation & offsetting
- Relationship between primary financial statements

Introduce principles for disclosures
- Materiality
- Communication

IFRS

Proposed profit or loss and OCI

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Retain profit or loss as subtotal or total

- Primary picture of the return an entity has generated
  - Common starting point for analysis
- Two approaches:
  - Narrow use of OCI
  - Broad use of OCI
- Present as one or two statements

Narrow use of OCI

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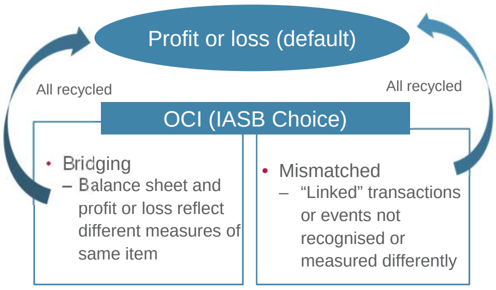

Broader use of OCI

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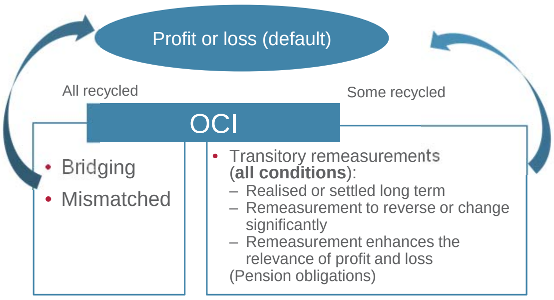

Timetable

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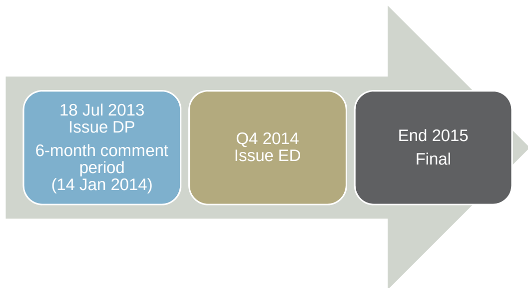

More information

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- Discussion Paper
  http://go.ifrs.org/DP-Conceptual-Framework-July-2013
- Snapshot
  http://go.ifrs.org/Snapshot-DP-Conceptual-Framework-2013
- *Conceptual Framework* website
  http://go.ifrs.org/Conceptual-Framework
- Existing *Conceptual Framework* including (Chapters 1 & 3)
  http://eifrs.ifrs.org/eifrs/bnstandards/en/2013/conceptual framework.pdf

Questions

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Q&A and discussion

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Demonstrating FBT for MBA students

Alan Jagolinzer
Associate Professor of Accounting Director, Ph.D. Program in Accounting
University of Colorado

Alan Jagolinzer
Associate Professor of Accounting

Overview

- My personal experience with MBA teaching
- Understanding the MBA audience
- The "Articulating Economic Truth" perspective
- The value proposition: changes and differences
- My view on interpretations
- A meaningful project

My personal experience with MBA teaching

- Advanced course in IFRS, selected as the "advanced core financial reporting option" at Stanford (2004-2010)
- Approximately 100 bankers, hedge fund traders, CEOs, CFOs, consultants, former accountants in the audience
- Stanford MBA Distinguished Teaching Award 2010

Understanding the MBA audience

- They expect to be bored
- They expect the course to be tedious and technical
- Some think they already know the material
- They all think that financial reporting rules are stagnant
- They all have personal experience and need us to map what they learn to that environment
- We will not perform well unless we provide the "value prop" behind the tedium

The "Articulating Economic Truth" perspective

- I tell the students my fundamental objective is to communicate "Economic Truth"
- Simplistic construct that more or less captures OB12

General purpose financial reports provide information about the financial position of a reporting entity, which is information about the entity's economic resources and the claims against the reporting entity. Financial reports also provide information about the effects of transactions and other events that change a reporting entity's economic resources and claims. Both types of information provide useful input for decisions about providing resources to an entity.

The "Articulating Economic Truth" perspective

Discussion of <u>every</u> topic comes back to:

- Does this treatment articulate economic truth?
- If you were a manager, how could you comply with this treatment and still obscure economic truth?
- Is there some alternative treatment that might better articulate economic truth?

This teaching framework allows us to articulate why IASB and FASB revisit/revise standards and perhaps why IASB and FASB converge to different standards

The value proposition: changes and differences

Regardless of backgrounds, no one in the MBA audience is aware of all the changes taking place at FASB/IASB

The most interesting discussions revolve around

- why standards are being revised
- whether proposed standards would improve articulation of "Economic Truth"
- why two firms utilize different choices within similar standards (what are the incentives to do so and what are the implications?)
- why differences still exist between GAAP and IFRS

The value proposition: changes and differences

Example: IAS 39 changes before 1/2005 EU transition

Mandated derivatives and other financial instruments be marked-to-market

"C'est a juste titre que la Commission a decide de ne pas y inclure les normes IAS 32 et IAS 39 relatives a la comptabilisation des instruments financiers, qui surient des consequences nefastes pour la stabilite financiere."


LE PRESIDENT DE LA REPUBLIQUE

Monsieur le Président,

Cher Ami,

Monsieur Romano PRODI
Président de la Commission européenne

The value proposition: changes and differences

Why did French banks fight so strongly against IAS 39?

If you were holding a long position in French banks, does this provide some investment-relevant information?

This context provides a very interesting discussion about the way we *should* account for financial instruments

e.g., why don't we impose a historical cost valuation model for interest-rate swaps?

My view on interpretations

NEVER RELY ON SOMEONE ELSE'S INTERPRETATION OF SOURCE GUIDANCE

Students should form their own interpretations from ***directly reading the actual standards***

- Empowers students in dialogue with auditors, regulators, and attorneys
- Allows students to consider whether to advocate for standards changes
- Great opportunity for us to talk about BCs and dissenting opinions (the "Leisenrings")

A meaningful project

Student groups write and submit a comment letter on a recent exposure draft or change proposal

- Students learn where to find proposed changes
- Students learn to think proactively about these changes
- Students may consider becoming activists for future changes
- Students learn what others think about proposed changes (which may offer investment-relevant info)

Student groups are randomly selected to present their comment letters in front of a real standard-setter

Question 6 (15 points):

Below are excerpts from an actual comment letter, written to the FASB on March 7, 2003.

Dear Board Members:

We are writing in response to the FASB's Invitation to Comment on accounting for stock options to express our concern that the process is basically flawed because the Invitation to Comment specifically directed respondents not to comment on whether stock options granted to employees result in compensation expense for the issuing company.

As many of the comment letters that have been submitted make clear, that is precisely the threshold question about which many experts disagree. It seems quite odd to us that you would want your respondents to pass over that crucial question. We would therefore urge the FASB - consistent with the historical commitment to due process - to carefully weigh the comments of those who nonetheless chose to address it.

…a number of letters make the point that the real "cost" of employee stock options is, in fact, already accounted for and disclosed to investors through diluted earnings per share. Herman Miller, Inc., for example, commented that "an issuing company does not bear the 'costs' associated with stock options. Instead, the true cost results from the potential dilution in the ownership of existing shareholders" (emphasis in original). Similarly, the Association for Financial Professionals, which includes approximately 14,000 financial executives employed by more than 5,000 corporations and other organizations, commented that "[t]he cost of stock options is reflected in fully diluted earnings-per-share, under current accounting rules."

… a mandatory expensing standard will not give investors accurate or reliable information - instead, they will get exactly the opposite. The very nature of employee stock options makes it impossible to measure what they "cost" at the time they are granted. …Moreover, the Black-Scholes model, and others like it, are complex mathematical formulas that require a wide variety of subjective assumptions. This means that using such models to record charges to a company's profit and loss statement would result in potential material misstatements of that company's financial results - not more accurate and transparent financial reporting.

…we are concerned that a mandatory expensing standard will inflict a fatal blow on broad-based stock option plans, which we believe should be encouraged, not eliminated. A number of experts and employee benefits practitioners have predicted that, if expensing were mandated, companies would cut back on all-employee plans, which would become much more "expensive" for working families in America.

…In sum, timely, accurate and meaningful disclosures, coupled with shareholder approval of all stock option plans, are the accounting and corporate governance reforms that, in our view, will best serve investors. They are far better than mandatory expensing which will effectively end the use of broad-based stock option plans and their ability to contribute to increases in productivity, the expansion of employee ownership, and to growing the economy.

Thank you for considering our views.

Sincerely,
Sen. Mike Enzi, R-Wyo.
Sen. George Allen, R-Va.
Sen. Barbara Boxer, D-Calif.
Sen. Joe Lieberman, D-Conn.
Sen. John Warner, R-Va.
Sen. Patty Murray, D-Wash.
Sen. John Ensign, R-Nev.
Sen. Harry Reid, D-Nev.
Sen. Larry Craig, R-Idaho
Sen. Maria Cantwell, D-Wash.
Sen. Conrad Burns, R-Mont.
Sen. Debbie Stabenow, D-Mich.
Sen. Pete Domenici, R-N.M.
Sen. Edward Kennedy, D-Mass.
Sen. Gordon Smith, R-Ore.

REQUIRED: Briefly explain whether you agree or disagree with these Senators' assessment. Please provide some logic to support your position.

BC13 Furthermore, that governments in some countries have a policy of encouraging employee share ownership is not a valid reason for according these types of plans a different accounting treatment, because it is not the role of financial reporting to give favourable accounting treatment to particular transactions to encourage entities to enter into them. For example, governments might wish to encourage entities to provide pensions to their employees, to lessen the future burden on the state, but that does not mean that pension costs should be excluded from the financial statements. To do so would impair the quality of financial reporting. The purpose of financial reporting is to provide information to users of financial statements, to assist them in making economic decisions. The omission of expenses from the financial statements does not change the fact that those expenses have been incurred. The omission of expenses causes reported profits to be overstated and hence the financial statements are not neutral, are less transparent and comparable, and are potentially misleading to users.

'There is no cost to the entity, therefore there is no expense'

BC40 Some argue that because share-based payments do not require the entity to sacrifice any cash or other assets, there is no cost to the entity, and therefore no expense should be recognised.

BC41 The Board regards this argument as unsound, because it overlooks that:

(a) every time an entity receives resources as consideration for the issue of equity instruments, there is no outflow of cash or other assets, and on every other occasion the resources received as consideration for the issue of equity instruments are recognised in the financial statements; and

(b) the expense arises from the consumption of those resources, not from an outflow of assets.

BC42 In other words, irrespective of whether one accepts that there is a cost to the entity, an accounting entry is required to recognise the resources received as consideration for the issue of equity instruments, just as it is on other occasions when equity instruments are issued.

'Earnings per share is "hit twice"'

BC54 Some argue that any cost arising from share-based payment transactions is already recognised in the dilution of earnings per share (EPS). If an expense were recognised in the income statement, EPS would be 'hit twice'.

BC55 However, the Board noted that this result is appropriate. For example, if the entity paid the employees in cash for their services and the cash was then returned to the entity, as consideration for the issue of share options, the effect on EPS would be the same as issuing those options direct to the employees.

BC56 The dual effect on EPS simply reflects the two economic events that have occurred: the entity has issued shares or share options, thereby increasing the number of shares included in the EPS calculation—although, in the case of options, only to the extent that the options are regarded as dilutive—and it has also consumed the resources it received for those options, thereby decreasing earnings. This is illustrated by the plant and machinery example mentioned in paragraphs BC42 and BC43. Issuing shares affects the number of shares in the EPS calculation, and the consumption (depreciation) of the asset affects earnings.

BC57 In summary, the Board concluded that the dual effect on diluted EPS is not double-counting the effects of a share or share option grant—the same effect is not counted twice. Rather, two different effects are each counted once.

'Adverse economic consequences'

BC58 Some argue that to require recognition (or greater recognition) of employee share-based payment would have adverse economic consequences, in that it might discourage entities from introducing or continuing employee share plans.

BC59 Others argue that if the introduction of accounting changes did lead to a reduction in the use of employee share plans, it might be because the requirement for entities to account properly for employee share plans had revealed the economic consequences of such plans. They argue that this would correct the present economic distortion, whereby entities obtain and consume resources by issuing valuable shares or share options without accounting for those transactions.

BC60 In any event, the Board noted that the role of accounting is to report transactions and events in a neutral manner, not to give 'favourable' treatment to particular transactions to encourage entities to engage in those transactions. To do so would impair the quality of financial reporting. The omission of expenses from the financial statements does not change the fact that those expenses have been incurred.

Framework Based Teaching for an MBA student audience

Summary

- The MBA audience wants a “value prop”
- The “Articulating Economic Truth” perspective helps provide context for why we (and whether we should) observe changes and differences
- Students should formulate their own interpretations from reading standards
- Students can learn to become proactive through the comment letter project

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