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
Conceptual Framework CPE Session #11

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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
Introduction to Framework-based Teaching (FBT)

Michael Wells  
Director, IFRS Education Initiative  
IASB
Conceptual Framework CPE Session #11

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

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

Amalgam1 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.

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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.

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

<table>
<thead>
<tr>
<th></th>
<th>Amalgam</th>
<th>Ation</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Carrying amount</td>
<td>Fair value</td>
</tr>
<tr>
<td></td>
<td>$'millions'</td>
<td>$'millions'</td>
</tr>
<tr>
<td>Identifiable assets</td>
<td>300,000</td>
<td>600,000</td>
</tr>
<tr>
<td>Liabilities</td>
<td>(200,000)</td>
<td>(190,000)</td>
</tr>
<tr>
<td>Contingent liabilities</td>
<td>–</td>
<td>(10,000)</td>
</tr>
<tr>
<td></td>
<td>100,000</td>
<td>400,000</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Question</th>
</tr>
</thead>
<tbody>
<tr>
<td>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?</td>
</tr>
<tr>
<td>How would you advise Mr J when he is developing an accounting policy for the acquisition of Ation in Amalgam’s consolidated financial statements?</td>
</tr>
<tr>
<td>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?</td>
</tr>
<tr>
<td>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?</td>
</tr>
<tr>
<td>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?</td>
</tr>
</tbody>
</table>
IASB project to improve the Conceptual Framework

Ronald Lott
FASB Seconded to the IASB's Conceptual Framework project
The views expressed in this presentation are those of the presenter, not necessarily those of the IASB or IFRS Foundation.

International Financial Reporting Standards

Conceptual Framework
3 August 2013

Session overview

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

Why?

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

Where are we?

- Objective
- Qualitative characteristics
- Reporting entity
- ED (2010)
- Completed
- Now
- Everything else

Objective of financial reporting

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

Qualitative characteristics

- Relevance
- Faithful representation
- Fundamental qualitative characteristics
- Enhancing characteristics
- Comparability
- Understandability
- Variability
- Timeliness

Useful
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

Existing definitions

<table>
<thead>
<tr>
<th>Asset [of an entity]</th>
<th>Liability [of an entity]</th>
</tr>
</thead>
<tbody>
<tr>
<td>a resource controlled by the entity</td>
<td>a present obligation of the entity</td>
</tr>
<tr>
<td>as a result of past events</td>
<td>arising from past events</td>
</tr>
<tr>
<td>from which future economic benefits are expected to flow to the entity</td>
<td>the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits</td>
</tr>
</tbody>
</table>

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?

Possible revised definitions

<table>
<thead>
<tr>
<th>Asset [of an entity]</th>
<th>Liability [of an entity]</th>
</tr>
</thead>
<tbody>
<tr>
<td>A present economic resource controlled by the entity as a result of past events</td>
<td>a present obligation of the entity to transfer an economic resource as a result of past events</td>
</tr>
<tr>
<td>An economic resource = a right, or other source of value, that is capable of producing economic benefits</td>
<td></td>
</tr>
</tbody>
</table>

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

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
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

Example: Changes in Equity

<table>
<thead>
<tr>
<th></th>
<th>Existing shareholders of parent</th>
<th>Non-controlling interests (NCI)</th>
<th>Obligation to issue shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>Opening 1 January 20X2</td>
<td>10,000</td>
<td>20,000</td>
<td>4,000</td>
</tr>
<tr>
<td>Written option issued</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total profit/comprehensive income for 20X2</td>
<td>-</td>
<td>3,500</td>
<td>200</td>
</tr>
<tr>
<td>Change in fair value of written option</td>
<td>-</td>
<td>1,000</td>
<td>-</td>
</tr>
<tr>
<td>31 December 20X2</td>
<td>10,000</td>
<td>24,500</td>
<td>4,200 4,000 42,700</td>
</tr>
</tbody>
</table>

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

Presentation & disclosures: Current problems

- Not currently addressed
- Presentation How to present performance?
- Profit or loss
- OCI
- Conceptual Framework project
- Disclosures Poorly targeted
- Disclosure initiatives

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
Proposed profit or loss and OCI

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

Profit or loss (default)

OCI (IASB Choice)

• Bridging
  • Balance sheet and profit or loss reflect different measures of same item
• Mismatched
  • “Linked” transactions or events not recognised or measured differently

Broader use of OCI

Profit or loss (default)

OCI

• Bridging
• Mismatched
  • Transitory remeasurements (all conditions):
    – Realised or settled long term
    – Remeasurement to reverse or change significantly
    – Remeasurement enhances the relevance of profit and loss (Pension obligations)

Timetable

18 Jul 2013
Issue DP
6-month comment period (14 Jan 2014)
Q4 2014
Issue ED
End 2015
Final

More information

• Discussion Paper
• Snapshot
  http://go.ifrs.org/Snapshot-Conceptual-Framework-2013
• Conceptual Framework website
  http://go.ifrs.org/Conceptual-Framework
• Existing Conceptual Framework
  including (Chapters 1 & 3)
The Conceptual Framework—Framework-based Teaching workshop and IASB project update

Q&A and discussion

Michael Wells  
*Director, IFRS Education Initiative*  
**IASB**

Ronald Lott  
*FASB staff seconded to the IASB’s Conceptual Framework project*
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Demonstrating FBT for MBA students

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

Discussion of every 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.
Framework Based Teaching for an MBA student audience

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

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 suriront des consequences nefastes pour la stabilite financiere."

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?

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, disgas of granting options to employees, or other 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 'cost' 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 100,000 financial executives employed by more than 5,000 corporations and other organizations, commented that "[the] 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 affect a broad base of stock-based incentive plans, which we believe companies encourage in order to maintain a level of stock ownership and proprietary interests in their business... We are concerned that this result will also mean an end to the use of broad-based stock plan 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,

...
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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Q&A and discussion

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