Debunking common ‘conceptual’ misunderstandings

Prepared by: Michael Wells

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Addis Ababa

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Accounting and Audit Board of Ethiopia

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Established under proclamation no 847/2006

Common 'conceptual' misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
Conceptual Framework = IFRS constitution	The *Conceptual Framework* never overrides an IFRS (see purpose and status of *Conceptual Framework*). In absence of an IFRS, the *Conceptual Framework* is in the hierarchy for developing an accounting policy (see IAS 8.11(b))

Common ‘Conceptual’ Misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
Objective of IFRS financial information = inform entity’s tax return	Objective = provide financial information about the reporting entity that is useful to primary users—existing and potential investors, lenders and other creditors who cannot demand information directly to them—in making decisions about providing resources to the entity (eg buy, sell, hold) (¶OB 2 and OB5)

Common ‘conceptual’ misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
Measured with reliability = precise	Reliability = complete, neutral and free from error (see ¶4.38)

Common 'conceptual' misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
Matching expenses to income = underlying concept/qualitative characteristic in the Conceptual Framework	Expenses are only decreases in assets/increase in liabilities in current period that result in decreased equity except…(¶4.25(b)) Qualitative characteristics are only relevance and faithful representation (fundamental) and comparability, verifiability, timely and understandability (enhancing) (¶QC4)

Common 'conceptual' misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
Materiality is based on size alone.	Information is material if omitting it or misstating it could influence decisions that users make on the basis of financial information about a specific reporting entity. In other words, materiality is an entity-specific aspect of relevance based on the nature or magnitude, or both, of the items to which the information relates in the context of an individual entity's financial report. (QC¶11)

Common 'conceptual' misunderstandings

Myth	Clarification
An entity must account for mmaterial items	Accounting policies need not be applied when the effect of applying them is immaterial. (IAS 8¶8 and ¶BC20–BC22) Financial statements do not comply with IFRS if they contain either material errors or immaterial errors made intentionally to achieve a particular presentation of an entity's financial position, financial performance or cash flows (IAS 8¶41)

Common 'conceptual' misunderstandings

Myth	Clarification
An entity must disclose immaterial items	An entity need not provide a specific disclosure required by an IFRS if the information is not material (IAS 1¶31)

Common 'conceptual' misunderstandings

Myth	Clarification
Comparability = uniformity	For information to be comparable, like things must look alike and different things must look different. (QC¶23) Making unlike things look alike does not provide information that is most useful to primary users—existing and potential investors lenders and other creditors that cannot demand information from the entity.

Common 'conceptual' misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
There are two measurement bases in IFRS—historical cost and fair value	The *Conceptual Framework* describes a number of observed measurement conventions including historical cost. (¶4.54–4.56) Standards provide further conventions—for example net realisable value, value in use, the equity method, adjustments for hedge accounting and first time adoption. IFRS 13 provides a measurement concept—fair value.

Common ‘conceptual’ misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
There is a concept for historical cost	The *Conceptual Framework* only describes historical cost as being ‘recorded at the amount of cash or cash equivalents paid or the fair value of the consideration given to acquire them at the time of their acquisition.’ (¶4.55(a)) Consequently, the IASB is inconsistent in its codification of historical cost and the IFRS Interpretation’s Committee receives many requests for interpretation of cost.

Common 'conceptual' misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
Using the fair value model requires more judgement than using the cost model	Fair value model involves measuring <u>only</u> fair value. Cost model involves measuring: • historical cost (for initial recognition) • depreciation to reflect the consumption of the item's service potential (judgements include: components, depreciation method, useful life, residual value (like fair value of older item)) • value in use and fair value less costs to sell, if impairment indicated • what carrying amount would have been, had impairment not occurred (for limiting reversals of prior period impairments)

Common ‘conceptual’ misunderstandings

Myth	Clarification—the *Conceptual Framework* includes…
There is a concept for other comprehensive income (OCI)	The *Conceptual Framework* defines financial performance with reference to income and expenses. It observes that several measures of such performance could be presented (a display/presentation issue). (¶4.24–4.28)

The root causes of financial reporting anomalies

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Framework-based approach for applying IFRS

- What are the economics of the phenomenon (eg transaction or event)?
- What information about the phenomenon is relevant for informing resource allocation decisions by existing and potential investors and lenders who cannot require information directly and that can be faithfully represented etc?
- Then consider IFRS requirements
- Make judgements to develop accounting policy
- Make judgements and estimates to apply the requirements with rigour and consistency

Controlling interest buys non-controlling interest (NCI) criticism: what are investors saying?

Warren Buffett (2013) "nonsensical accounting rule that I described in last year's letter required that we enter these purchases on our books at $1.8 billion less than we paid, a process that reduced Berkshire's book value... This weird accounting, you should understand, instantly increased Berkshire's excess of intrinsic value over book value by the same $1.8 billion."

Dennis Jullens, UBS (2010) "This accounting adjustment caused return on equity to increase from 17% in 2008 to 119% in 2009... (p68) However, the principal reason for Roche's return on equity is accounting rather than underlying economics."

Controlling interest buys non-controlling interest (NCI)

Transaction: group pays CU10 billion to buy the NCI.

Economics: group pays CU10 billion to settle NCI's CU10 billion claim.

IFRS 10 accounting:

Debit Equity: NCI (carrying amount of claim extinguished)	CU4 billion
Credit Asset: cash (money left the group)	(CU10 billion)
.: Debit Equity (transaction between equity holders)	CU6 billion

What's the problem? Before buying the NCI, its carrying amount was measured at CU6 billion less than its economic value CU10 billion.

Why does this happen? Although NCI was initially measured at its fair value (assuming fair value NCI alternative in IFRS 3 used), it is subsequently remeasured based on group accounting for the subsidiary.

Controlling interest buys non-controlling interest (NCI)

What is the root cause?

- non-recognition of some assets (for example, internally generated brands); and
- mixed measurements for many recognised assets (ie assets are not all reflected in accounting at their economic value).

Treasury shares

Transaction: entity pays CU100 million to buy 25% of its equity.

Economics: entity pays CU100 million to extinguish the former shareholders' CU100 million equity claim.

» **before buy-back**: net assets CU400 million = equity CU400 million

» **buy-back:** assets ↓CU100 million and equity ↓CU100 million

» **after buy-back:** net assets CU300 million = equity CU300 million

Accounting:

» **before buy-back:** net assets CU80 million = equity CU80 million

» **buy-back (IAS 32):** assets ↓CU100 million and equity ↓CU100 million

» **after buy-back:** net assets CU-20 million = equity CU-20 million

Treasury shares

What’s the problem? After the buy-back, the carrying amount of the entity’s equity is –CU20 million (CU80 million – CU100 million) when its market capitalisation is CU300 million.

Why does this happen? Equity is the residual of measuring the group’s assets and liabilities using a mix of measurements. Consequently, in this example, before and after the buy-back equity is measured at amounts significantly lower than its economic value. Consistently with the economics, the purchase of treasury shares is measured at market value when the equity claim is settled.

Root causes = non-recognition of some assets; and mixed measurements for many recognised assets (ie assets are not all reflected in accounting at their economic value).

Change in own credit risk
what was being said?

Bank Profits From Accounting Rules

By Yalman Onaran - June 5, 2009 00:01 EDT

Another $2.7 billion before taxes came from an accounting rule that lets a company record income when the value of its own debt falls. That reflects the possibility a company could buy back bonds at a discount, generating a profit. In reality, when a bank can't fund such a transaction, the gain is an accounting quirk, Weiss says.

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Doubts are also raised with regard to the application of FVA to the *liability* side of banks. For instance, the suggested methodology (the so-called "own credit risk") to determine the fair value of debt instruments issued by banks entails that, if the rating of a bank deteriorates, the value of its equity will ultimately increase (since the difference in revaluation of debt instruments is accounted in the profit and loss account). This outcome is counter-intuitive and can be misleading for shareholders and creditors.

Change in own credit risk continued
the economics

Entity issues promises to pay $1,000,000 in 10 years.

» **Promise issued on Day 1:** generated $613,913 cash inflow (5% discount factor on Day 1, before downgrade)

» **If promise were issued on Day 3:** it would generate $385,543 cash inflow (10% discount factor after Day 2 downgrade)

Why the change in discount rate?

» Lenders demand a higher interest rate to compensate them for the increased credit risk credit risk evidenced by the credit rating downgraded on Day 2.

» On Day 3 entity could realise the gain of $228,370 by repurchasing its debt at $385,543.

Change in own credit risk continued the economics v the accounting

Economics: (using market capitalisation as a measure of equity)

- » before the downgrade: net assets CU4,000,000 = equity CU4,000,000
- » downgrade: net assets ↓CU1,000,000 and equity ↓CU1,000,000
- » after downgrade: net assets CU3,000,000 = equity CU3,000,000

Accounting (fair value model assets and liabilities (= economics)

Accounting (fair value model liabilities; cost model assets):

- » before downgrade: net assets CU2,000,000 = equity CU2,000,000
- » downgrade: net assets ↑CU228,370 and equity ↑CU228,370
- » after downgrade: net assets CU2,228,370 = equity CU2,228,370

Accounting (cost model used for liabilities and assets):

- » Before and after downgrade: net assets/equity = CU2,000,000

Change in own credit risk continued root cause of the anomaly

What's the problem? Accounting reflects (net) income (gain) when the economic is a (net) expense (loss).

Why does this happen? Although the accounting for the liability is consistent with the economics, the economic impairment of the entity's assets is understated in the accounting (if it is recognised at all) because:

» the impaired assets are either not recognised (for example, internally generated brands, goodwill etc); or

» the accounting measurement of its assets is disconnected from the economics (eg historical cost is not updated to reflect net upward changes in economics and consequently a buffer against the recognition of impairments is created).

Change in own credit risk continued
root cause of the anomaly

Root causes:

» non-recognition of some assets (for example, internally generated brands); and

» mixed measurements for many recognised assets (ie assets are not all reflected in accounting at their economic value).