ACCA

SBR

Strategic Business Reporting

Study Text

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Acknowledgements

The objective of the review is to ensure that the material properly covers the syllabus and study guide outcomes, used by the examining team in setting the exams, in the appropriate breadth and depth. The review does not ensure that every eventuality, combination or application of examinable topics is addressed by the ACCA Approved Content. Nor does the review comprise a detailed technical check of the content as the Approved Content Provider has its own quality assurance processes in place in this respect.

Contents

Introduction

This document references IFRS® Standards and IAS® Standards, which are authored by the International Accounting Standards Board (the Board), and published in the 2018 IFRS Standards Red Book.

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How to use the Materials

Strategic Business Reporting is an exam at the Strategic Professional level of the ACCA qualification. It assumes knowledge acquired at the Fundamentals level including the core technical capabilities to prepare and analyse financial reports for single and combined entities

These Kaplan Publishing learning materials have been carefully designed to make your learning experience as easy as possible and to give you the best chances of success in your examinations.

The product range contains a number of features to help you in the study process. They include:

1 Detailed study guide and syllabus objectives

2 Description of the examination

3 Study skills and revision guidance

4 Study text

5 Question practice

The sections on the study guide, the syllabus objectives, the examination and study skills should all be read before you commence your studies. They are designed to familiarise you with the nature and content of the examination and give you tips on how to best to approach your learning.

The **Study Text** comprises the main learning materials and gives guidance as to the importance of topics and where other related resources can be found. Each chapter includes:

- The **learning objectives** contained in each chapter, which have been carefully mapped to the examining body's own syllabus learning objectives or outcomes. You should use these to check you have a clear understanding of all the topics on which you might be assessed in the examination.
- The **chapter diagram** provides a visual reference for the content in the chapter, giving an overview of the topics and how they link together.
- The **content** for each topic area commences with a brief explanation or definition to put the topic into context before covering the topic in detail. You should follow your studying of the content with a review of the illustration/s. These are worked examples which will help you to understand better how to apply the content for the topic.

- **Test your understanding** sections provide an opportunity to assess your understanding of the key topics by applying what you have learned to short questions. Answers can be found at the back of each chapter.
- **Summary diagrams** complete each chapter to show the important links between topics and the overall content of the paper. These diagrams should be used to check that you have covered and understood the core topics before moving on.
- **Question practice** is provided through this text.

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Our Quality Coordinator will work with our technical team to verify the error and take action to ensure it is corrected in future editions.

Icon Explanations

Definition – Key definitions that you will need to learn from the core content.

Key point – Identifies topics that are key to success and are often examined.

Supplementary reading – These sections will help to provide a deeper understanding of core areas. The supplementary reading is **NOT** optional reading. It is vital to provide you with the breadth of knowledge you will need to address the wide range of topics within your syllabus that could feature in an exam question. **Reference to this text is vital when self studying.**

Test your understanding – Exercises for you to complete to ensure that you have understood the topics just learned.

Illustration – Worked examples help you understand the core content better.

Tutorial note – Included to explain some of the technical points in more detail.

Footsteps – Helpful tutor tips.

On-line subscribers

Our on-line resources are designed to increase the flexibility of your learning materials and provide you with immediate feedback on how your studies are progressing.

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Ask your local customer services staff if you are not already a subscriber and wish to join.

Paper introduction

Paper background

The Strategic Business Reporting (SBR) syllabus requires students to examine corporate reporting from a number of perspectives, not only from the point of view of the preparer of corporate reports, but also from the perspective of a variety of different stakeholders such as finance providers. The syllabus further requires the assessment and evaluation of the reporting decisions made by management and their implications for a range of stakeholders and entities. It also explores the professional and ethical responsibilities of the accountant to these stakeholders.

Objectives of the syllabus

Candidates should be able to:

- Apply fundamental ethical and professional principles to ethical dilemmas and discuss the consequences of unethical behaviour
- Evaluate the appropriateness of the financial reporting framework and critically discuss changes in accounting regulation
- Apply professional judgement in the reporting of the financial performance of a range of entities
- Prepare the financial statements of groups of entities
- Interpret financial statements for different stakeholders
- Communicate the impact of changes and potential changes in accounting regulation on financial reporting.

ACCA Performance Objectives

In order to become a member of the ACCA, as a trainee accountant you will need to demonstrate that you have achieved nine performance objectives. Performance objectives are indicators of effective performance and set the minimum standard of work that trainees are expected to achieve and demonstrate in the workplace. They are divided into key areas of knowledge which are closely linked to the exam syllabus.

There are five Essential performance objectives and a choice of fifteen Technical performance objectives which are divided into five areas.

The performance objectives which link to this exam are:

1 Ethics and professionalism (Essential)

2 Stakeholder relationship management (Essential)

3 Record and process transactions and events (Technical)

4 Prepare external financial reports (Technical)

5 Analyse and interpret financial reports (Technical)

The following link provides an in depth insight into all of the performance objectives:

https://www.accaglobal.com/content/dam/ACCA_Global/Students/per/PER-Performance-objectives-achieve.pdf

Progression

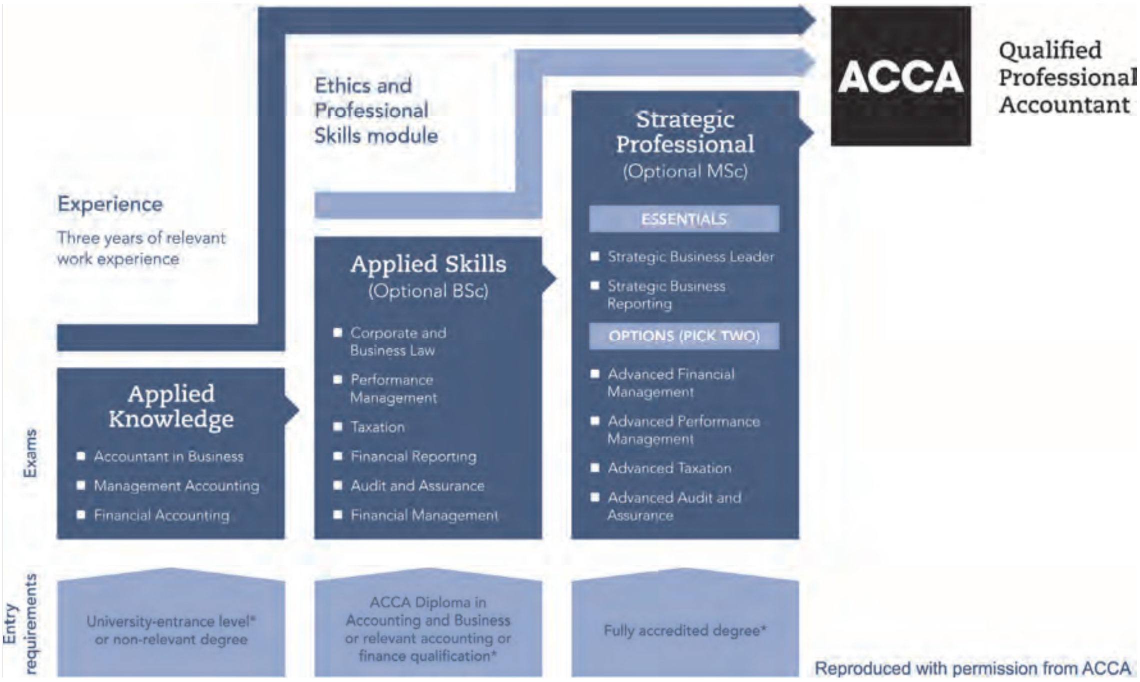
There are two elements of progression that we can measure: first how quickly students move through individual topics within a subject; and second how quickly they move from one course to the next. We know that there is an optimum for both, but it can vary from subject to subject and from student to student. However, using data and our experience of student performance over many years, we can make some generalisations.

A fixed period of study set out at the start of a course with key milestones is important. This can be within a subject, for example ‘I will finish this topic by 30 June’, or for overall achievement, such as ‘I want to be qualified by the end of next year’.

Your qualification is cumulative, as earlier papers provide a foundation for your subsequent studies, so do not allow there to be too big a gap between one subject and another. We know that exams encourage techniques that lead to some degree of short term retention, the result being that you will simply forget much of what you have already learned unless it is refreshed (look up Ebbinghaus Forgetting Curve for more details on this). This makes it more difficult as you move from one subject to another: not only will you have to learn the new subject, you will also have to relearn all the underpinning knowledge as well. This is very inefficient and slows down your overall progression which makes it more likely you may not succeed at all.

In addition, delaying your studies slows your path to qualification which can have negative impacts on your career, postponing the opportunity to apply for higher level positions and therefore higher pay.

You can use the following diagram showing the whole structure of your qualification to help you keep track of your progress.



Syllabus objectives

We have reproduced the ACCA's syllabus below:

A FUNDAMENTAL ETHICAL AND PROFESSIONAL PRINCIPLES

1 Professional behaviour and compliance with accounting standards

(a) Appraise and discuss the ethical and professional issues in advising on corporate reporting.[3]

(b) Assess the relevance and importance of ethical and professional issues in complying with accounting standards.[3]

2 Ethical requirements of corporate reporting and the consequences of unethical behaviour

(a) Appraise the potential ethical implications of professional and managerial decisions in the preparation of corporate reports.[3]

(b) Assess the consequences of not upholding ethical principles in the preparation of corporate reports.[3]

(c) Identify related parties and assess the implications of related party relationships in the preparation of corporate reports.[3]

Chapter

1

Frameworks

Chapter learning objectives

Upon completion of this chapter you will be able to:

- Discuss the importance of a conceptual framework in underpinning the production of accounting standards
- Discuss the objectives of financial reporting including disclosure of information that can be used to help assess management's stewardship of the entity's resources and the limitations of financial reporting
- Discuss the nature of the qualitative characteristics of useful financial information
- Explain the roles of prudence and substance over form in financial reporting
- Discuss the high level measurement uncertainty that can make financial information less relevant
- Evaluate the decisions made by management on recognition, derecognition and measurement
- Critically discuss and apply the definitions of the elements of financial statements
- Discuss and apply the definitions of 'fair value' measurement and 'active market'
- Discuss and apply the 'fair value hierarchy'
- Discuss and apply the principles of highest and best use, most advantageous and principal market
- Explain the circumstances where an entity may use a valuation technique.

PER

One of the PER performance objectives (PO7) is to prepare external financial reports. You take part in preparing and reviewing financial statements – and all accompanying information – and you do it in accordance with legal and regulatory requirements. Working through this chapter should help you understand how to demonstrate that objective.

1 Introduction

This chapter considers two documents issued by the International Accounting Standards Board (the Board) that underpin a range of IFRS and IAS Standards:

- The *Conceptual Framework for Financial Reporting* – used by the Board when developing or revising an IFRS or IAS Standard, and by preparers of financial statements when no relevant IFRS or IAS Standard exists, and
- IFRS 13 *Fair Value Measurement* – used by preparers of financial statements when an IFRS or IAS Standard requires or allows the use of a fair value measurement (with some exceptions).

2 *Conceptual Framework for Financial Reporting*

Introduction

The importance of a conceptual framework

A conceptual framework is a set of theoretical principles and concepts that underlie the preparation and presentation of financial statements.

If no conceptual framework existed, then accounting standards would be produced on a haphazard basis as particular issues and circumstances arose. These accounting standards might be inconsistent with one another, or perhaps even contradictory.

A strong conceptual framework means that there are principles in place from which all future accounting standards draw. It also acts as a reference point for the preparers of financial statements if no accounting standard governs a particular transaction (although this will be extremely rare).

This section of the text considers the contents of the *Conceptual Framework for Financial Reporting* (*Conceptual Framework*) in more detail.

Background

The *Framework for the Presentation and Preparation of Financial Statements* was issued in 1989.

In 2004 the Board and the US Financial Accounting Standards Board (FASB) started a joint project to revise their respective frameworks. As a result of this project the Board issued the *Conceptual Framework for Financial Reporting* in 2010. Most of the text from the 1989 *Framework* was simply rolled over but two chapters were revised. These covered:

- The objective of financial reporting
- The qualitative characteristics of useful financial information.

The Board and the FASB subsequently suspended work on this joint project.

Several criticisms emerged of the 2010 *Conceptual Framework*

- It did not cover certain areas, such as derecognition, and presentation and disclosure
- Guidance in some areas was unclear, such as with regards to measurement uncertainty
- Some aspects were out of date, such as recognition criteria for assets and liabilities.

As a result of criticism, the *Conceptual Framework* was identified as a priority project so, in 2012, the Board restarted this project without the FASB.
A Discussion Paper outlining the Board's thinking was published in 2013 and an Exposure Draft of the proposed amendments was published in 2015. Feedback from these documents informed the revised *Conceptual Framework*, which was published in 2018.

The purpose of the *Conceptual Framework*

The purpose of the *Conceptual Framework* is to assist:

(a) the Board when developing new IFRS Standards, helping to ensure that these are based on consistent concepts

(b) preparers of financial statements when no IFRS Standard applies to a particular transaction, or when an IFRS Standard offers a choice of accounting policy

(c) all parties when understanding and interpreting IFRS Standards.

The *Conceptual Framework* is not an accounting standard. It does not override the requirements in a particular IFRS Standard.

The objective of financial reporting

The *Conceptual Framework* states that the purpose of financial reporting is to provide information to current and potential investors, lenders and other creditors that will enable them to make decisions about providing economic resources to an entity.

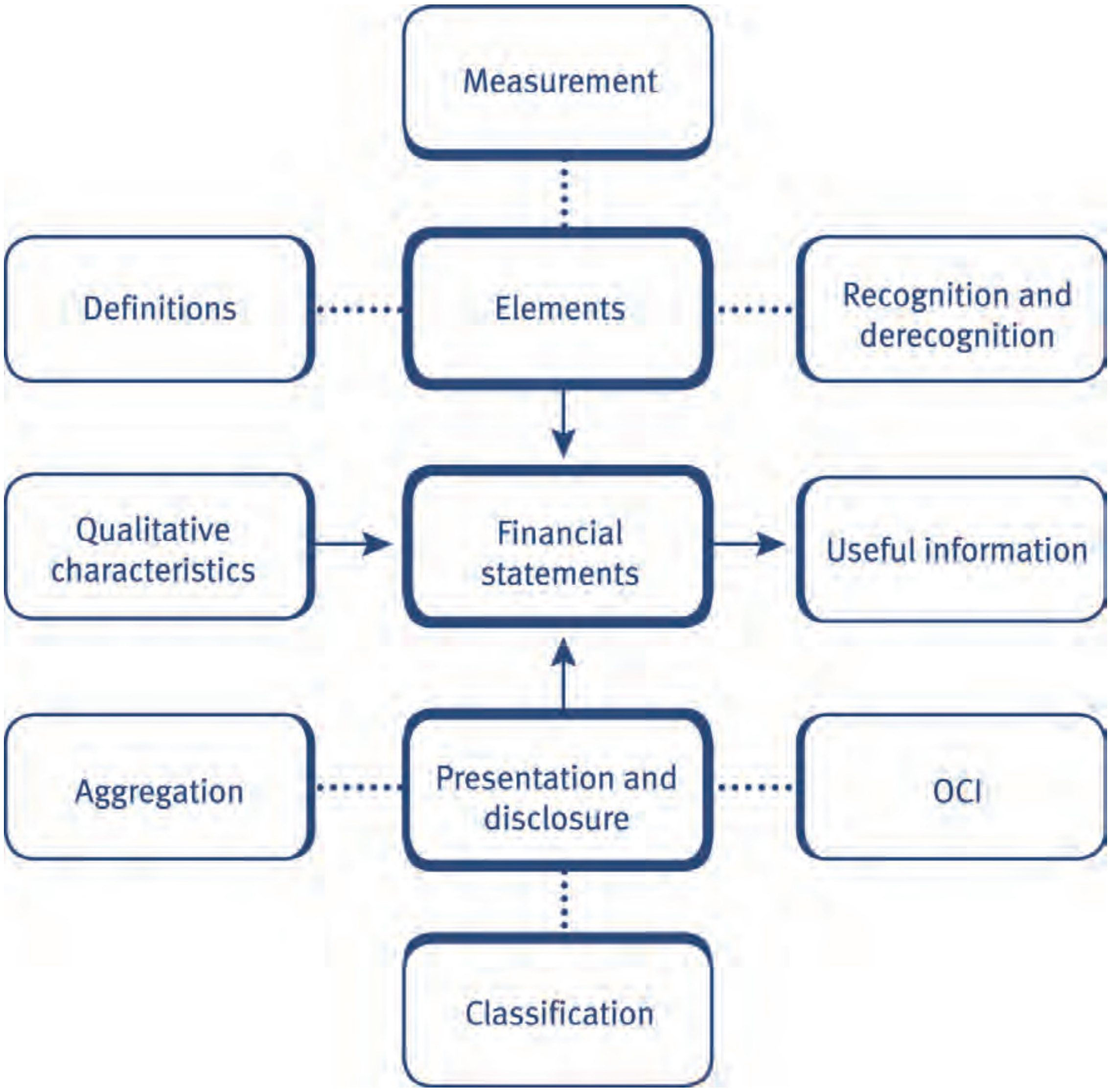
If investors, lenders and creditors are going to make these decisions then they require information that will help them to assess:

- an entity's potential future cash flows, and
- management's stewardship of the entity's economic resources.

To assess an entity's future cash flows, users need information about:

- economic resources of the entity e.g. assets
- economic claims against the entity e.g. liabilities and equity
- changes in economic resources and claims e.g. income and expenses.

Summary of the content of the Conceptual Framework



Qualitative characteristics of useful financial information

Fundamental characteristics

The *Conceptual Framework* states that financial information is only useful if it is:

- relevant
- a faithful representation of an entity's transactions.

Relevance and faithful representation are the **fundamental characteristics** of useful financial information.

1 Relevance

Relevant information will make an impact on the decisions made by users of the financial statements.

Relevance requires management to consider materiality. An item is material if its omission or misstatement would influence the economic decisions of users.

2 Faithful representation

A faithful representation of a transaction would represent its economic substance rather than its legal form.

A perfectly faithful representation would be:

- complete
- neutral
- free from error.

The Board note that this is not fully achievable, but that these qualities should be maximised.

When preparing financial reports, preparers should exercise **prudence**. Prudence means that assets and income are not overstated and liabilities and expenses are not understated. However, this does not mean that assets and income should be purposefully understated, or liabilities and expenses purposefully overstated. Such intentional misstatements are not neutral.

Enhancing characteristics

In addition to the two fundamental qualitative characteristics, there are four enhancing qualitative characteristics of useful financial information:

- **Comparability** – investors should be able to compare an entity's financial information year-on-year, and one entity's financial information with another.
- **Timeliness** – older information is less useful.

- **Verifiability** – knowledgeable users should be able to agree that a particular depiction of a transaction offers a faithful representation.
- **Understandability** – information should be presented as clearly and concisely as possible.

Cost constraint

Producing financial reports takes time and costs money.

When developing IFRS Standards, the Board assesses whether the benefits of reporting particular information outweigh the costs involved in providing it.

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Cost constraint – an example

IFRS 16 *Leases,* which replaced IAS 17 *Leases*, radically changed lessee accounting by requiring all lessees to recognise an asset and liability at the inception of a lease (unless the lease is short-term or of minimal value). However, IFRS 16 did not change the accounting treatment of leases by lessors. This was because most stakeholders did not believe that the requirements relating to lessors in IAS 17 were ‘broken’. The perceived time and costs involved in implementing substantial changes to lessor accounting was therefore believed to outweigh any benefits.

Financial statements and the reporting entity

Financial statements

The *Conceptual Framework* notes that financial statements are a particular type of financial report.

The purpose of financial statements is to provide information to users about an entity’s:

- assets
- liabilities
- equity
- income
- expenses.

This information is provided in:

- a statement of financial position
- statements of financial performance
- other statements, such as statements of cash flows and notes.

Financial statements are prepared on the assumption that the entity is a **going concern**. This means that it will continue to operate for the foreseeable future. If this assumption is not accurate, then the financial statements should be prepared on a different basis.

The reporting entity

A reporting entity is one that prepares financial statements (either through choice, or as a result of legal requirements).

Financial statements produced for two or more entities that are not parent/subsidiaries are called ‘combined financial statements’. It can be difficult in these circumstances to determine the boundary of the reporting entity. Note that the *Conceptual Framework* does not stipulate how or when to prepare combined financial statements, although the Board may develop a standard on this issue in the future.

Financial statements produced for a reporting entity that comprises a parent company and its subsidiaries are called ‘consolidated financial statements’. These financial statements show the parent and its subsidiaries as a single economic entity. This information is important for investors in the parent because their economic returns are dependent on distributions from the subsidiary to the parent.

Unconsolidated financial statements also provide useful information to investors in a parent company (for example, about the level of distributable reserves) but they are not a substitute for information provided in consolidated financial statements.

The elements of financial statements

The elements are the building blocks of financial statements:

- statements of financial position report assets, liabilities and equity
- statements of financial performance report income and expenses.

Economic resource	Asset	‘**A present economic resource controlled by an entity as a result of a past event**’ (para 4.3).
Economic claim	Liability	‘**A present obligation of the entity to transfer an economic resource as a result of a past even**t’ (para 4.26).
	Equity	The residual interest in the net assets of an entity.

Changes in economic resources and claims as a result of financial performance	Income	Increases in assets or decreases in liabilities that result in an increase to equity (excluding contributions from equity holders).
	Expenses	Decreases in assets or increases in liabilities that result in decreases to equity (excluding distributions to equity holders).
Other changes in economic resources and claims		Contributions from, and distributions to, equity holders. Exchanges of assets and liabilities that do not increase or decrease equity.

An economic resource is a '**right that has the potential to produce economic benefits**' (para 4.4).

Recognition and derecognition

Recognition

Items are only recognised in the financial statements if they meet the definition of one of the elements. However, not all items meeting these definitions are recognised.

Elements are recognised if recognition provides users with useful financial information. In other words recognition must provide:

- relevant information
- a faithful representation of the asset or liability, and resulting income, expenses or equity movements.

Recognition might not provide relevant information if there is uncertainty over the existence of the element or if there is a low probability of an inflow or outflow of economic resources.

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Recognition – an example

IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* prohibits recognition of contingent liabilities and assets because it is not probable that resources will flow from or to the reporting entity.

Recognition of an element might not provide a faithful representation if there is a very high degree of measurement uncertainty.

Judgement is required in deciding if recognition of an element is appropriate. This is why specific recognition criteria vary from one IFRS Standard to another.

If an asset or liability is not recognised, disclosures may be required to ensure users fully understand the reporting entity's economic transactions and the implications that these may have on future earnings and future cash flows.

Test your understanding 1 – Bottle

Bottle operates in the publishing industry. The Bottle brand is highly respected and, as a result, the books published by Bottle receive extensive coverage both online and in national and international press. The brand is internally generated and, in accordance with IAS 38 *Intangible Assets*, is not recognised in Bottle's financial statements.

Required:

Discuss the extent to which the accounting treatment of the Bottle brand is consistent with the *Conceptual Framework*.

Derecognition

Derecognition is the removal of some or all of an asset or liability from the statement of financial position. This normally occurs when the entity:

- loses control of the asset, or
- has no present obligation for the liability.

Accounting for derecognition should faithfully represent the changes in an entity's net assets, as well as any assets or liabilities retained.

This is achieved by:

- derecognising any transferred, expired or consumed component
- recognising a gain or loss on the above, and
- recognising any retained component.

Sometimes an entity might appear to have transferred an asset or liability. However, derecognition would not be appropriate if exposure to variations in the element's economic benefits is retained.

Derecognition – an example

An entity sells a building for $2 million and retains the right to buy it back for $3 million in five years' time. At the date of sale, the building had a fair value of $7 million. Property prices are expected to rise.

The entity does not derecognise the building from its statement of financial position. The entity has not lost control over the building because its ability to buy the building back for substantially less than fair value enables it to benefit from future price rises.

The cash received would be recognised as a loan liability.

Measurement

When recognised in the financial statements, elements must be quantified in monetary terms.

The *Conceptual Framework* outlines two broad measurement bases:

- Historical cost
- Current value (this includes fair value, value-in-use, and current cost).

Selecting a measurement base

The information provided to users by the measurement base must be useful. In other words it must be relevant and offer a faithful representation of the transactions that have occurred.

When selecting a measurement basis, the *Conceptual Framework* states that relevance is maximised if the following are considered:

- The characteristics of the asset and/or liability
- The ways in which the asset and/or liability contribute to future cash flows.

This applies to the Board when developing or revising an IFRS Standard. It also applies to preparers of financial statements when applying an IFRS Standard that permits a choice of measurement bases.

Selecting a measurement basis – an example

Mist purchases an investment property in a prime location. Property prices are increasing in this area. As such, the value of the property is susceptible to market factors, and could substantially differ from the initial purchase price paid by Mist.

IAS 40 *Investment Property* offers a choice of accounting policy. Mist might choose:

- The fair value model if they intend to sell the asset because this most faithfully represents the future cash flows they will receive from its eventual disposal
- The cost model if they have no intention of selling the property because this best matches the rental income generated with the cost of the asset.

Note that Mist might have no intention of selling the asset but still conclude that the fair value model provides the most relevant information about the building to financial statement users. This might be because increases in property prices will enable Mist to charge higher rents to its tenants, thus contributing to greater net cash inflows.

Presentation and disclosure

Effective presentation and disclosure

Effective presentation and disclosure is a balance between allowing entities to flexibly report relevant information about their financial performance and position, and requiring information that enables comparisons to be drawn year-on-year and with other entities.

The Board believe that:

- entity specific information is more useful than standardised descriptions
- duplication makes financial information less understandable.

Classification

Classification of an asset or liability into separate components may provide relevant information if the components have different characteristics.

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Classification – an example

At the reporting date, Bottled owed $10 million to a bank.

$1 million of this loan is due for repayment within 12 months and is presented as a current liability.

The remaining $9 million is presented as a non-current liability.

Classifying the liability in this way provides additional information to users, which helps them to assess Bottled's future cash flows, as well as its solvency.

Offsetting classifies dissimilar items together and is therefore generally not appropriate.

Classification – an example

Ellipsis has $3 million in an account held with Animal Bank. This money earns 1% interest per year. The balance is presented in Ellipsis' statement of financial position as a current asset.

Ellipsis also has a $1 million overdraft in an account held with Sotoro Bank. This incurs an interest charge of 10% a year. This overdraft is presented in Ellipsis' statement of financial position as a current liability.

Ellipsis must not offset its $3 million cash balance with its $1 million overdraft e.g. it cannot show a net $2 million current asset. The cash balance and the overdraft have different characteristics and risks, and offsetting would obscure these differences. Separate classification provides relevant information to the users of the financial statements.

Aggregation

Aggregation refers to the adding together of items that have shared characteristics.

Aggregation is useful because it summarises information that would otherwise be too detailed. However, too much aggregation obscures relevant information.

Different levels of aggregation will be required throughout the financial statements. For example, the statement of profit or loss may be heavily aggregated, but accompanying disclosure notes will disaggregate the information.

Profit or loss and other comprehensive income

The *Conceptual Framework* states that the statement of profit or loss is the primary source of information about an entity's financial performance. As such, income and expenses should normally be recognised in this statement.

When developing or revising standards, the Board notes that it might require an income or expense to be presented in other comprehensive income if it results from remeasuring an item to current value and if this means that:

- profit or loss provides more relevant information, or
- a more faithful representation is provided of an entity's performance.

Income and expenditure included in other comprehensive income should be reclassified to profit or loss when doing so results in profit or loss providing more relevant information. However, the Board may decide that reclassification is not appropriate if there is no clear basis for identifying the amount or timing of the reclassification.

Other comprehensive income – an example

Entity A owns land and buildings that are accounted for using the revaluation model in IAS 16 *Property, Plant and Equipment*. At the reporting date, Entity A revalued these assets from $250 million to $300 million. IAS 16 stipulates that the $50 million gain must be recognised in other comprehensive income.

Property, plant and equipment is not held for trading, but is instead used over more than one period to produce, supply, store and distribute goods. Including this $50 million gain in profit or loss would not offer a faithful representation of Entity A's financial performance during the period.

Test your understanding 2 – Cryptocurrencies

Cryptocurrencies are digital currencies that operate independently of a central bank. The most well-known cryptocurrency is the bitcoin. Some businesses now accept bitcoins in place of traditional currencies.

The price of one bitcoin was $20 at the beginning of 2013. This rose to a high of just under $20,000 in December 2017. In February 2018, its price dropped 50% in 16 days. The price of a bitcoin is therefore highly volatile. Investors can earn large returns by buying bitcoins on an exchange when the quoted price is low and selling them on an exchange when the quoted price rises.

Cryptocurrencies like the bitcoin have proved problematic with regards to financial reporting because they do not fall within the scope of an issued IFRS or IAS Standard. As such, preparers of financial statements must use the *Conceptual Framework* to devise an accounting treatment that provides useful information to financial statement users.

Required:

Using the *Conceptual Framework*, discuss how an entity might account for an investment in bitcoins that it holds to trade.

Criticisms of financial reporting

The *Conceptual Framework* provides a principles-based approach to financial reporting. However, users are increasingly critical of the very nature of financial reporting. As a result, new forms of non-financial reporting have emerged, which are discussed later in this text.

Some of the criticisms of financial reporting are discussed below.

Historical information

The statement of profit or loss shows the performance of the entity over the past reporting period. However, investors are more interested in future profits. Moreover by the time financial statements are published, the information presented will be several months out of date.

Unrecognised assets and liabilities

Some assets and liabilities are not recognised in financial statements prepared using IFRS Standards, such as internally generated goodwill. This means that no asset is recognised in respect of the company's reputation or employee skills even though these may play a pivotal role in its success.

Clutter

Financial reports have been criticised in recent years for becoming increasingly cluttered as a result of extensive disclosure requirements. These disclosures can be very generic and they make it harder for the users to find relevant information.

Financial/non-financial information

Current and past profits and cash flows are not the only determinate of future success. Long-term success is also dependent on how an entity is governed, the risks to which it is exposed and how well these are managed, and whether its business activities are sustainable into the medium and long-term. Financial statements prepared in accordance with IFRS Standards say little about these areas.

Estimates

Financial reporting uses many estimates (e.g. depreciation rates). Estimates are subjective and could be manipulated in order to achieve particular profit targets. The subjective nature of estimates reduces comparability between companies.

The statement of cash flows somewhat compensates for the impact of accounting estimates. However, the cash position of an entity can also be window-dressed (such as by delaying payments to suppliers).

Professional judgement

Financial reporting requires judgement. For example, judgement is required by lessors when classifying a lease as a finance lease or an operating lease. Subjective decisions reduce comparability and increase the risk of bias.

Use of historical cost

Some accounting standards, such as IAS 16 *Property, Plant and Equipment*, permit assets to be measured at historical cost. In times of rising prices, the statement of profit or loss will not show a sustainable level of profit.

Policy choices

Some standards, such as IAS 16 *Property, Plant and Equipment* and IAS 40 *Investment Properties*, allow entities to choose between cost and fair value models. This makes it harder to investors to compare financial statements on a like-for-like basis.

3 IFRS 13 *Fair Value Measurement*

Introduction

The objective of IFRS 13 is to provide a single source of guidance for fair value measurement where it is required by a reporting standard, rather than it being spread throughout several reporting standards.

Many accounting standards require or allow items to be measured at fair value. Some examples from your prior studies include:

- IAS 16 *Property, Plant and Equipment*, which allows entities to measure property, plant and equipment at fair value
- IFRS 3 *Business Combinations*, which requires the identifiable net assets of a subsidiary to be measured at fair value at the acquisition date.

Scope

IFRS 13 does not apply to:

- share-based payment transactions (IFRS 2 *Share-based Payments*)
- leases (IFRS 16 *Leases*).

The definition of fair value

Fair value is defined as **'the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement** date' (IFRS 13, para 9).

Market participants are knowledgeable, third parties. When pricing an asset or a liability, they would take into account:

- Condition
- Location
- Restrictions on use.

It should be assumed that market participants are not forced into transactions (i.e. they are not suffering from cash flow shortages).

IFRS 13 notes that there are various approaches to determining the fair value of an asset or liability:

- Market approaches (valuations based on recent sales prices)
- Cost approaches (valuations based on replacement cost)
- Income approaches (valuations based on financial forecasts).

Whatever approach is taken, the aim is always the same – to estimate the price that would be transferred in a transaction with a market participant.

The price

Fair value is a market-based measurement, not one that is entity specific. As such, when determining the price at which an asset would be sold (or the price paid to transfer a liability), observable data from active markets should be used where possible.

An **active market** is a market where transactions for the asset or liability occur frequently.

IFRS 13 classifies inputs into valuation techniques into three levels.

- **Level 1** inputs are quoted prices for identical assets in active markets.
- **Level 2** inputs are observable prices that are not level 1 inputs. This may include:
  - Quoted prices for similar assets in active markets
  - Quoted prices for identical assets in less active markets
  - Observable inputs that are not prices (such as interest rates).
- **Level 3** inputs are unobservable. This could include cash or profit forecasts using an entity's own data.

  A significant adjustment to a level 2 input would lead to it being categorised as a level 3 input.

Priority is given to level 1 inputs. The lowest priority is given to level 3 inputs.

e.g

Inputs to determine fair value

IFRS 13 gives the following examples of inputs used to determine fair value:

	Asset	Example
Level 1	Equity shares in a listed entity	Unadjusted quoted prices in an active market.
Level 2	Building held and used	Price per square metre for the building from observable market data, such as observed transactions for similar buildings in similar locations.
Level 3	Cash-generating unit	Profit or cash flow forecast using own data.

Test your understanding 3 – Baklava

Baklava has an investment property that is measured at fair value. This property is rented out on short-term leases.

The directors wish to fair value the property by estimating the present value of the net cash flows that the property will generate for Baklava. They argue that this best reflects the way in which the building will generate economic benefits for Baklava.

The building is unique, although there have been many sales of similar buildings in the local area.

Required:

Discuss whether the valuation technique suggested by the directors complies with International Financial Reporting Standards.

Markets

The price received when an asset is sold (or paid when a liability is transferred) may differ depending on the specific market where the transaction occurs.

Principal market

IFRS 13 says that fair value should be measured by reference to the **principal market**.

The principal market is the market with the greatest activity for the asset or liability being measured.

The entity must be able to access the principal market at the measurement date. This means that the principal market for the same asset can differ between entities.

Most advantageous market

If there is no principal market, then fair value is measured by reference to prices in the most advantageous market.

The most advantageous market is the one that maximises the net amount received from selling an asset (or minimises the amount paid to transfer a liability).

Transaction costs (such as legal and broker fees) will play a role in deciding which market is most advantageous. However, fair value is not adjusted for transaction costs because they are a characteristic of the market, rather than the asset.

Test your understanding 4 – Markets

An asset is sold in two different active markets at different prices. An entity enters into transactions in both markets and can access the price in those markets for the asset at the measurement date as follows:

	Market 1	Market 2
	$	$
Price	26	25
Transaction costs	(3)	(1)
Transport costs	(2)	(2)
Net price received	21	22

What is the fair value of the asset if:

(a) market 1 is the principal market for the asset?

(b) no principal market can be determined?

Non-financial assets

What is a non-financial asset?

The difference between financial and non-financial assets is covered in detail in Chapter 12. Financial assets include:

- Contractual rights to receive cash (such as receivables)
- Investments in equity shares.

Non-financial assets include:

- Property, plant and equipment
- Intangible assets.

The fair value of a non-financial asset

IFRS 13 says that the fair value of a non-financial asset should be based on its **highest and best use**.

The highest and best use of an asset is the use that a market participant would adopt in order to maximise its value.

The current use of a non-financial asset can be assumed to be the highest and best use, unless evidence exists to the contrary.

The highest and best use should take into account uses that are:

- physically possible
- legally permissible
- financially feasible.

IFRS 13 says a use can be legally permissible even if it is not legally approved.

Test your understanding 5 – Five Quarters

Five Quarters has purchased 100% of the ordinary shares of Three Halves and is trying to determine the fair value of the net assets at the acquisition date.

Three Halves owns land that is currently developed for industrial use. The fair value of the land if used in a manufacturing operation is $5 million.

Many nearby plots of land have been developed for residential use (as high-rise apartment buildings). The land owned by Three Halves does not have planning permission for residential use, although permission has been granted for similar plots of land. The fair value of Three Halves' land as a vacant site for residential development is $6 million. However, transformation costs of $0.3 million would need to be incurred to get the land into this condition.

Required:

How should the fair value of the land be determined?

Investor perspective

Below is an extract from a disclosure note about the fair value of an entity's financial assets and liabilities:

Fair value of financial instruments

	Level 1 $m	Level 2 $m	Level 3 $m
Financial asset – traded equities	110	–	–
Financial liability – contingent consideration	–	–	33

The fair values of the traded equities have been determined by reference to market price quotations.

The fair value of contingent consideration is estimated based on the forecast future performance of the acquired business over a timeframe determined as part of the acquisition agreement, discounted as appropriate. Key assumptions include growth rates, expected selling volumes and prices and direct costs during the period.

This disclosure informs investors that the fair value of investments in equities has been derived using level 1 inputs (quoted prices for identical assets in active markets). This measurement required no judgement, eliminating the risk of bias, and can be verified by knowledgeable third parties.

In contrast, the disclosure informs investors that the fair value of the contingent liability has been derived using level 3 inputs. This measurement therefore involved a high level of judgement, increasing the risk of management bias. There is also a risk that the amount the entity eventually pays will differ materially from the year-end carrying amount. For this reason, the disclosure provides additional information about how management have estimated the fair value of the liability, so that the investors can assess the adequacy of the methodology used and reach a conclusion as to whether the level of measurement uncertainty is acceptable to them.

Due to the level of risk, some investors may decide to sell their shares in an entity if its fair value measurements are overly reliant on level 3 inputs.

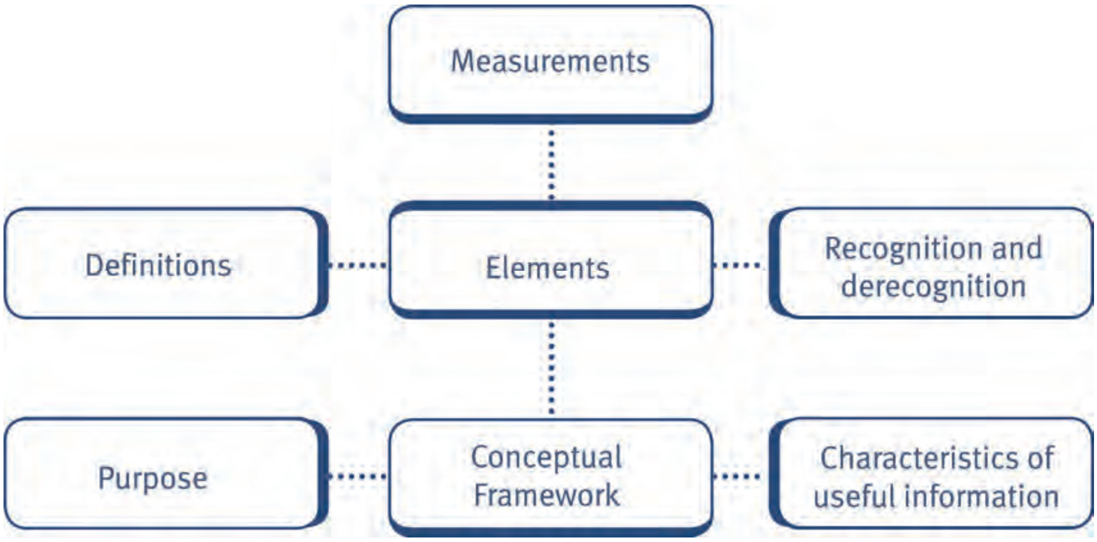
Test your understanding 6 – IFRS 13 and the *Conceptual Framework*

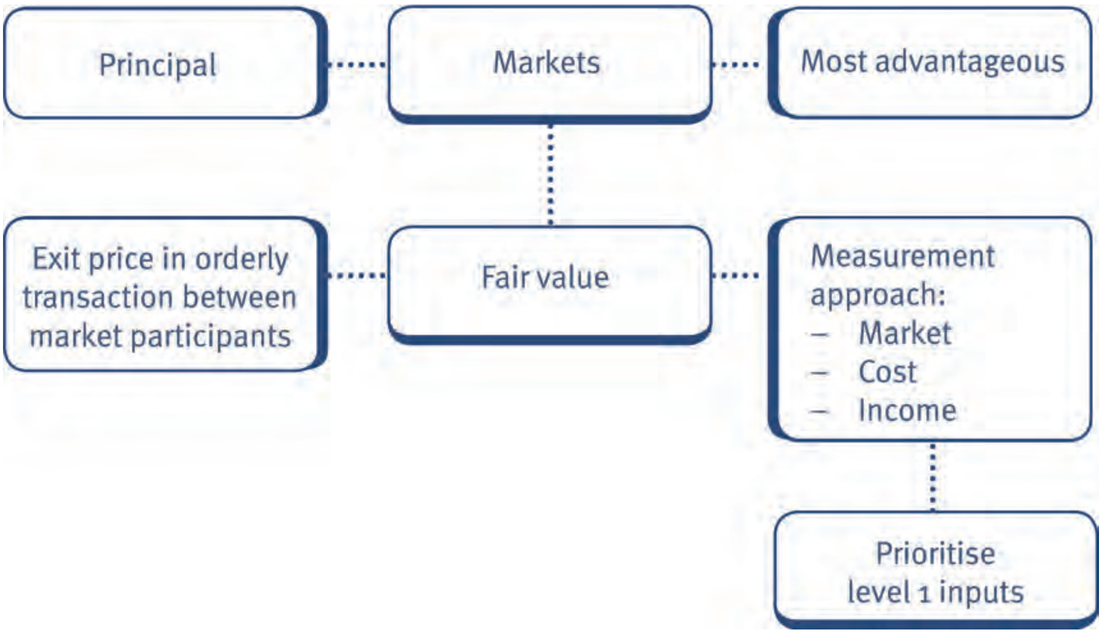
The *Conceptual Framework* says that the purpose of financial reporting is to provide useful financial information to users of the financial statements.

Required:

Discuss how the application of IFRS 13 enhances the usefulness of financial information. Your answer should refer to the qualitative characteristics of useful financial information.

4 Chapter summary





Test your understanding answers

Test your understanding 1 – Bottle
The brand is an economic resource controlled by Bottle. It has the potential to bring economic benefits because of the exposure that Bottle-branded books receive. Despite meeting the definition of an element, the brand is not recognised in the financial statements. However, the *Conceptual Framework* states that elements should only be recognised if this provides relevant information, or a faithful representation of the asset or liability. If there is a high degree of measurement uncertainty then recognition may not provide a faithful representation. The cost of an internally generated brand cannot be reliably measured. This is because the costs of setting up and developing the brand cannot be separated from the operating costs of the business. The fair value of a brand is also very difficult to determine because brands are unique. Thus, it would seem that the accounting treatment of the brand, per IAS 38 *Intangible Assets*, is consistent with the *Conceptual Framework*.

Test your understanding 2 – Cryptocurrencies
One of the purposes of the *Conceptual Framework* is to assist preparers of financial statements when no IFRS Standard applies to a particular transaction. The definition of an asset in the *Conceptual Framework* is an economic resource controlled by an entity from a past event. Bitcoins meet this definition because they can be traded or used to buy goods and therefore have the potential of producing economic benefits. Items should be recognised in the financial statements if they meet the definition of an element and if recognition provides relevant information and a faithful representation of the underlying item. If bitcoins are traded then information about bitcoin investments will help users when assessing an entity's future cash flows. As such, recognition is appropriate. When measuring elements, the *Conceptual Framework* outlines two broad measurement bases: • historical cost, and • current value.

When selecting a measurement basis, the *Conceptual Framework* states that relevance is maximised if the following are considered:

- The characteristics of the asset and/or liability
- The ways in which the asset and/or liability contribute to future cash flows.

In terms of future cash flows, many entities sell investments in bitcoin in order to benefit from fair value gains. However, the historical cost of a bitcoin purchase may differ significantly from its current value. As such, the shareholders of an entity that trades in bitcoins are likely to be interested in the current value of the investment because the eventual sale will have a significant impact on future net cash flows. Moreover, under historical cost, information about value changes is not normally reported until disposal. Therefore it would seem that a measurement based on current value – such as fair value – will provide relevant and timely information to shareholders.

The *Conceptual Framework* notes that profit or loss is the primary source of information about an entity's economic performance. However, income and expense might be reported in other comprehensive income if it results from remeasuring an item to current value and if this means that:

- profit or loss provides more relevant information, or
- a more faithful representation is provided of an entity's performance.

Whilst the value of a bitcoin is highly volatile, that value is likely to be extracted from a short-term sale. As such, it would seem that reporting gains and losses in profit or loss would provide the most relevant information about economic performance in the period.

In conclusion, by applying the *Conceptual Framework*, it would seem that an appropriate accounting treatment for an investment in bitcoins would be to measure it at fair value at the reporting date and to present the gains or losses in the statement of profit or loss.

Test your understanding 3 – Baklava

The directors' estimate of the future net cash flows that the building will generate is a level 3 input. IFRS 13 gives lowest priority to level 3 inputs. These should not be used if level 1 or level 2 inputs exist.

Observable data about the recent sales prices of similar properties is a level 2 input. The fair value of the building should therefore be based on these prices, with adjustments made as necessary to reflect the specific location and condition of Baklava's building.

Test your understanding 4 – Markets

(a) If Market 1 is the principal market then the fair value would be measured using the price that would be received in that market less transport costs. The fair value would therefore be $24 ($26 – $2). Transaction costs are ignored as they are not a characteristic of the asset.

(b) If neither market is the principal market for the asset then the fair value would be measured in the most advantageous market. The most advantageous market is the market that maximises the net amount received from the sale.

The net amount received in Market 2 ($22) is higher than the net amount received in Market 1 ($21). Market 2 is therefore the most advantageous market. This results in a fair value measurement of $23 ($25 – $2). IFRS 13 specifies that transaction costs play a role when determining which market is most advantageous but that they are not factored into the fair value measurement itself.

Test your understanding 5 – Five Quarters

Land is a non-financial asset. IFRS 13 says that the fair value of a non-financial asset should be based on its highest and best use. This is presumed to be its current use, unless evidence exists to the contrary.

The current use of the asset would suggest a fair value of $5 million.

However, there is evidence that market participants would be interested in developing the land for residential use.

Residential use of the land is not legally prohibited. Similar plots of land have been granted planning permission, so it is likely that this particular plot of land will also be granted planning permission.

If used for residential purposes, the fair value of the land would be $5.7 million ($6m – $0.3m).

It would seem that the land's highest and best use is for residential development. Its fair value is therefore $5.7 million.

Test your understanding 6 – IFRS 13 and the *Conceptual Framework*

To be useful, financial information must be relevant and provide a faithful representation of the transaction that an entity has entered into. A completely faithful representation is complete, neutral and free from error.

Measuring items at fair value is often argued to provide relevant information to an entity's stakeholders. However, IFRS 13 does not specify when assets or liabilities should be measured at fair value – this is governed by other IFRS and IAS Standards.

When measuring fair value, IFRS 13 requires entities to use a level 1 input when available – quoted prices for identical assets in active markets. These inputs require no judgement and so the resulting measurement should be neutral.

The prioritisation of observable inputs in IFRS 13 – both level 1 and level 2 – mean that the resulting valuations are verifiable.

IFRS 13 enhances comparability between entities. For example, management estimates – level 3 inputs – should only be used if no other inputs are available. Similarly, IFRS 13 requires entities to measure fair value from the perspective of a market participant, rather than an individual entity, which will aid investors when comparing one entity with another. Requirements to measure fair value using the principal market, and to base the fair value of non-financial assets using the highest and best use, reduce the scope for management bias and ensure that entities are determining fair value consistently.

Requirements to disclose estimation methods when a fair value is determined using level 3 inputs help ensure that financial statements are understandable.