CPA Ireland Skillnet

CPA Ireland Skillnet, is a training network that is funded by Skillnets, a state funded, enterprise led support body dedicated to the promotion and facilitation of training and up-skilling as key elements in sustaining Ireland's national competitiveness.
The CPA Ireland Skillnet provides excellent value CPE (continual Professional Education) in accountancy, law, tax and strategic personal development to accountants working both in practice and in industry. However our attendees are not limited to the accountancy field as we welcome all interested parties to our events.

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Trainee Accountant Workshop Series

March 2016

Current Issues in Advanced Corporate Reporting

Presenter: Martin Kelly: PhD, FCA, MBA, BSc

The Institute of Certified Public Accountants in Ireland

Introduction Format of Session

- EXAM FORMAT
- SYLLABUS
- SKILLS REQUIRED
- EXAMINATION TECHNIQUE

Introduction Format of Session

- ETHICAL ISSUES
- KEY EXAMPLES –From Past Case Studies
- CURRENT ISSUES
  - Conceptual Framework
  - Fair Value Reporting
  - Revenue recognition – IFRS 15
  - Sustainability and Integrated Reporting
  - Leasing

Exam Format

- Open book
- **3.5 hours** plus twenty minutes reading time
- Answer all questions

Syllabus

- This paper is the final test of candidates' ability to understand the theory of financial reporting and how to apply that knowledge to a number of practical accounting scenarios/issues
- Case study is designed to test students' ability to digest a considerable amount of detailed information about the affairs of a single company or group of companies.

Syllabus

- Narrative and computational
- Case study includes a range of current technical issues requiring, in many situations, substantial adjustments to draft figures provided in the question
- Case study requirement – normally up to four parts

Skills for Success

- **Preparation** – **practice questions** and be aware of current developments
- **Easy marks** – there are easy marks (e.g. some of the accounting adjustments). **Ethical Issues** should be relatively easy to spot
- **Don't** spend all your time on the 'complications/challenging' technical issues

Skills for Success

- Answer **ALL** questions and **ALL** parts of questions
- Be ruthless in **allocating your time – minutes per mark**
- If unsure re particular issue etc – **state your assumption**

Skills for Success

- Read the **requirements of the case first**, then begin to annotate the case study as you read through it
- Is there a **report** or **memorandum** required?
- Deconstruct the case – **what are key issues – computational/narrative**
- You have got to P2 – you are more than capable of gaining **50% or more!!!**

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Recent Past Papers

- Ethical issues
- Current issues

Don't Ignore these!

- Understand and apply a range of International Financial Accounting Standards
- Make adjustments – discuss impact on financial statements
- Prepare or draft key financial statements
- Interpret financial statements

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Recent Past Papers

- Not just number crunching
- Candidates were also required to explain the accounting treatment of various issues (such as legal claims), providing calculations were relevant and identifying any impact (SFP/SPLOCI) of the financial statements
- Professional judgement e.g. IAS36, IAS 37

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Be Organised

Reference material/notes

Have you looked at the <u>Articles</u> on CPA website?

- *An Approach to Advanced Corporate Reporting Examination Questions* – Martin Kelly
- *Preparing for Open Book Examinations (updated article)* – Paul Heaney
- *Lessons learned from Real World Consolidation* – Stephen McNamee

http://www.cpaireland.ie/students/study-support/professional-2/p2-advanced-corporate-reporting/p2-advanced-corporate-reporting-articles

Ethics -1

- Professional ethics are an inherent part of the profession http://www.cpaireland.ie/students/professional-ethics
- Ethical code – more than just rules
- Set of moral standards
- Fundamental principles: confidentiality, objectivity, professional behaviour, integrity and professional competence

Ethics -2

- Principles provide a basis for most appropriate course of action
- Ethical principles should be compatible with other values in life. e. g. choice between keeping your job and violating professional and ethical responsibilities
- Unethical practices have consequences for organisations

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Activity

- Review the ACR April 2014 paper and <u>identify the *ethical issues*</u> that might be relevant

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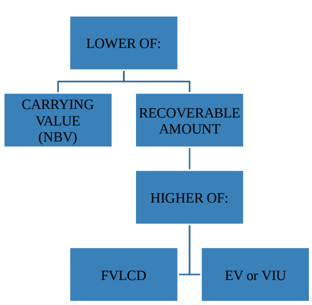
IAS36 - Impairment

ASSET RECOVERY



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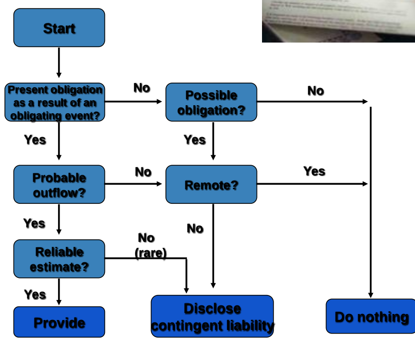
IAS37



IAS 10
Events After the Reporting Period

- ***Adjusting events***
  - Events after the reporting date and before the date of authorisation of the financial statements that provides evidence of conditions that ***existed at*** the reporting date
  - IAS 10 states that where there is a ***material*** adjusting event, the financial statements must be changed to reflect this event

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IAS 10
Events After the Reporting Period

- ***Non-adjusting events***
  - Event after the reporting date and before date of authorisation of financial statements that is indicative of conditions that ***arose after*** the reporting date
  - By definition, ***no adjustment*** required to amounts recognised in the financial statements but possible disclosure

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IAS38 – Intangible Assets

Internally Generated Intangible Assets

Research phase

Recognise as expense when incurred

Do not recognise <u>internally generated</u> brands, mastheads, publishing titles and customer lists

Development phase

Capitalise and amortise if certain conditions are met:

- **P** robable future economic benefits
- **I** intention to complete and use/sell
- **R** esources adequate to complete and use/sell
- **A** bility to use/sell
- **T** echnical feasibility
- **E** xpenditure can be reliably measured

Recognise as expense when incurred

Consolidation

- IFRS3 (revised), IFRS 10, IFRS11, IAS28 etc
- Know the basics
  - Easy marks – group structure/proforma
  - Additional notes – do workings e.g. intragroup current accounts/unrealised profits/fair value adjustments
  - Goodwill (will include fair value adjustments*) calculation
  - Consolidated retained earnings

Case Study
Issue / Adjustment

- Which accounting standards are applicable
- Justify your treatment of the issue based on the standard. (*you do not have to copy out large sections of the standard or parts of the exam paper*)
- Prepare any calculations required
- Draw up journals to deal with the issue

Current Issues

- Conceptual Framework
- Fair Value Accounting
- Revenue Recognition – IFRS 15
- Sustainability/Integrated Reporting
- Leasing and FRS102

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Conceptual Framework

- Principles which form the frame of reference for financial reporting
- Advantages
  - Avoid developing standards piecemeal
  - Less open to criticism (external)
- Problems
  - Cannot meet needs of multiple users
  - Harmonisation globally
- The first phase, Chapters 1-3, was published in 2010.

Conceptual Framework

- IASB Exposure Draft 2015
- **Chapters 1/2** - The objective of general purpose financial reporting. Qualitative characteristics of useful financial information
- **Chapter 3** – Financial Statements and the Reporting Entity
  - Fundamental characteristics – Relevance and Faithful representation
- Five other chapters

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Problems

- Decision-usefulness versus stewardship
- Reliability?
- Definitions
- Measurement
- FRC (2015) response (see CPA website)

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Discussion paper July 2013

- Remove notion of probability in definition of asset/liability
- Measurement – more than one basis
- Profit and loss and OCI – what items are recognised in each

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Approach

- Rationale for approach
- Calculations
- Journal to financial statements

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April 2014 - Adjustment

Beta Block sold some trade receivables, which arose during December 2013, to a factoring company on 31 December 2013.The trade receivables sold are unlikely to default in payment based on past experience but they are long dated with payment not due until 1 July 2014. Beta Block has given the factor a guarantee that it will reimburse any amounts not received from the factor.

April 2014 - Adjustment

Beta Block received €90 million from the factor, being 90% of the trade receivables sold. The trade receivables are not included in the statement of financial position of Beta Block and the balance of €9 million (10% of trade receivables factored) which has not been received from the factor has been written off against retained earnings.

Rationale

Debt factoring: Under IFRS 9 *financial instruments* a financial asset must be derecognised if:
(i) The contractual rights to the cash flows have expired (ii) The financial asset has been transferred, together with the risks and rewards.
Condition (ii) has clearly not been met.
Beta Block still bears the risks and rewards of ownership.

Calculation and Journal

Accordingly, the receivable must be reinstated.

	€m	€m
Dr Receivables (SFP)	90	
Cr Retained earnings		9
Cr Loan (current liabilities)		81

Journal to adjust financial statements

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April 2014 - Adjustment

As an incentive to persuade a new customer to buy a large quantity of a new drug, Gamma, Beta Block offered a deferred payment arrangement. The drug, with a selling price of €5 million, was delivered to the customer on 1 January 2013. The customer paid 20% of the selling price on that date. The balance will become payable on 1 January 2015.The applicable finance charge is 6% per annum. €5 million was recognised as revenue in the draft financial statements in respect of this transaction.

Rationale

This is an issue surrounding revenue recognition (IAS 18 *Revenue*).Where an extended period of credit is offered to a customer, revenue recognised as two elements: first the fair value of the goods on date of sale, and second, financing income. Future receipts from the customer should be discounted to present value at an imputed interest rate, in this case 6%.

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Rationale

The customer paid €1m on 1 January 2013 (€5m x 20%).
At that date the present value of the amount receivable on 1 January 2015 was (€5m x 80%) x 1 /(1.06)2 = €3,560,000 (nearest'000).

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Calculations

Revenue to be recognised in this transaction in the financial statements to the year ended 31 December 2013:

Sale of goods	
(€1,000,000 + €3,560,000)	= 4,560,000
Financing income	
(€3,560,000 x 6%) nearest 000s	= 214,000
Income to be recognised	= 4,774,000
Amount already recognised	€ 5,000,000

Journal

Reduce retained earnings by € 226,000

	Dr	Cr
SPLOCI (RE)	226,000	
Trade Receivables (SFP)		226,000

Therefore carrying amount of receivable
€ 4,000,000 – €226,000

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April 2015 - Issue 7

Due to a change in the company's product portfolio plans, an item of machinery with a carrying value of €22 million at 31 December 2014 (after adjusting for depreciation for the year) may be impaired due to a change in use. An impairment test, conducted on 31 December 2014, revealed its fair value less costs of disposal to be €16 million.

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April 2015

The asset is now expected to generate an annual net income of €3.8 million for the next five years at which point it would be disposed of for €4.2 million. an appropriate discount rate is 10%. The company charges depreciation at 20% on reducing balance method on machinery and equipment.

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Rationale

Under IAS 36 *Impairment*, the machinery needs to be tested for impairment.

If the recoverable amount is the higher of

(i) the value in use and

(ii) fair value less costs of disposal

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Calculation

	€m
carrying value	22
recoverable amount (€3.8 x 3.791) + (€4.2 x 0.681)	(17.3)
impairment	4.7

Journal – FS adjustment

	Dr	Cr
SPLOCI	4.7	
Asset value		4.7

April 2015 - Issue 6

On the 31 January 2015, €500,000 was paid to John Rowlings as compensation for his removal as mascot's director of marketing. as a result of a disagreement over the marketing strategy of the company, Mr Rowlings was dismissed by the managing director at the board meeting on 31 December 2014. in addition, a customer of mascot went into liquidation owing mascot €1 million at 31 December 2014. information in relation to the liquidation suggests that there is little chance that unsecured creditors will receive any money. the debt has increased to €1.2 million at the date of the winding-up order.

Discussion

Which Accounting Standard?

Fair Value Accounting

- The financial crisis of 2008 led to spotlight being put on FV accounting
- "The problems that exist in today's financial markets can be traced to many different factors. One factor that is recognized as having exacerbated these problems is fair-value accounting"

American Bankers Association, 2008 (quoted in Laux & Leuz, 2009)

- The charge is that FVA is pro-cyclical

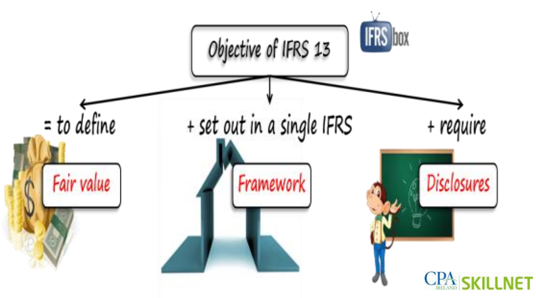
Fair Value Accounting

- Power (2010) analyses the rise of FVA through four mutually supporting conditions:
  - FVA proponents drawing on financial economics
  - Problems with accounting for derivatives
  - Transformation of the SOFP from a legal into an economic institution
  - The development of professional standard-setters

Fair Value Accounting

- IFRSs utilise 'fair value' concept, however, IFRSs do not require that all assets and liabilities are valued at fair value. For example, ***IFRS 9, IAS 16, IAS 40***.

Fair Value Debate



Definition of Fair Value

- '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'
- This is sometimes referred to as an **'exit price'**
- An 'orderly transaction' means that it is not a forced transaction (liquidation or distress sale)

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Definition of Fair Value

- An entity shall take into account the characteristics of the asset or liability if market participants would take those characteristics into account when pricing the asset or liability
- Such characteristics include:
  - The condition and location of the asset
  - Restrictions, if any, on the sale or use of the asset

Valuation Techniques

- When transactions are directly observable in a market, the determination of fair value can be relatively straightforward. In other circumstances, a valuation technique is used.
- IFRS 13 describes three valuation techniques:
  - **Market approach** uses prices generated by market transactions
  - **Income approach** converts future amounts to a single (present value) amount
  - **Cost approach** determines the value which reflects current replacement cost

Hierarchy of Inputs to Valuation Techniques

- **Level 1** - highest priority is given to quoted prices in active markets for identical assets or liabilities
- **Level 2** – observable inputs not included in level 1, e.g. quoted prices for similar assets or liabilities in active markets, quoted prices for identical or similar assets or liabilities in markets that are not active
- **Level 3** – unobservable inputs developed using best information available, e.g. entity's own data

Question

Year to 31 December 2015	**Asian Market**	**European Market**	**American Market**
Volume – units	4 million	2 million	1 million
Price	€19	€16	€22
Costs of entering market	€2	€2	€2
Transaction costs	€1	€2	€2

Beta Plc is reviewing the fair value valuation of certain assets and liabilities, It carries an asset that is traded in different markets and is unsure as to which valuation to use. The asset is to be valued at fair value under International Financial Reporting Standards.

Required
Discuss, with relevant calculations, how Beta Plc should value the above asset under IFRS13

Solution

Year to 31 December 2015	**Asian Market**	**European Market**	**American Market**
Volume – units	4 million	2 million	1 million
Price	€19	€16	€22
Costs of entering market	(€2)	(€2)	(€2)
Potential fair value	€17	€14	€20
Transaction costs	(€1)	(€2)	(€2)
Net profit	**€16**	**€12**	**€18**

Solution

- Principal market is the Asian market – highest activity /volume
- Most advantageous market is the American market as it has highest profit per unit
- Beta Plc should base its fair value on prices in the Asian market as it is principal market – fair value is €17
- If Beta Plc cannot access the Asian or European markets, or reliable information is not available, it would use American market.

IFRS 15 - *Revenue from Contracts with Customers*

- IFRS 15 – was issued in May 2014
- Strike a balance between IASB rules in IAS18, seen as too general, and the FASB regulations which were too numerous
- Replaces IAS18 and IAS 11 – effective on or after 1 January 2017
- IAS18 did not state clearly when or how an entity should separate a single transaction into components
- IAS18 provided very limited guidance on difference between selling a good and provision of service

IFRS 15 - *Revenue from Contracts with Customers*

- Under IFRS15 the transfer of goods and services is based upon the transfer of *control* rather than risks and rewards *as in IAS18*
- Control is direct the use of, and obtain substantially all the remaining benefits from the asset

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IFRS 15 – Five Steps

- Identify the contract with the customer
- Identify the separate performance obligations
- Determine the transaction price
- Allocate the transaction price to the performance obligations
- Recognise revenue when (or as) a performance obligation is satisfied

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Judgement

- Contracts with customers may not be in writing – can arise via customary business practice
- Whether benefits (consideration) are probable
- ?

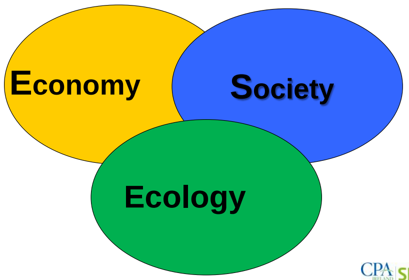
Limitations of Traditional Financial Reporting

- Measurement
- Too much information – disclosures
- Non-financial information
- Estimates
- Professional judgement

Sustainability Reporting

- Maximisation of profit motive
- Pressure for companies to widen their scope for corporate public accountability – stakeholders?
- Global Reporting Initiative (GRI) –voluntary

Triple Bottom Line - TBL



TBL

- Advocates argue that sustainability can be achieved if an organisation is financially secure; minimises environmental impacts; and acts in conformity with social expectations
- TBL is a very broad approach to reporting on social, environmental and economic performance
- Measurement problem

TBL/Sustainability Report – Real World

- http://www.novonordisk.com/sustainability/Focus/Our-Sustainability-Approach/Triple-Bottom-Line0.html
- http://www.shell.com/sustainability/sustainability-reporting-and-performance-data/sustainability-reports.html

Integrated Reporting

- Connect business strategy and financial and non-financial performance
- Connect business strategy and sustainability
- Holistic view of ‘value creation’

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Leasing and FRS102

- Review leasing examples from past papers
- FRS102

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