Financial Reporting Workshop

By Ferdinand Othieno

3 May 2019

Agenda – Two standards

1. **IFRS 13**
   – Definition of fair value
   – Fair value measurement
   – Disclosures
2. **IAS 8**
   – Errors, policies and estimates
   – Retrospective and prospective adjustments
   – Compliance with IAS 1

IFRS 13: Fair Value Measurement

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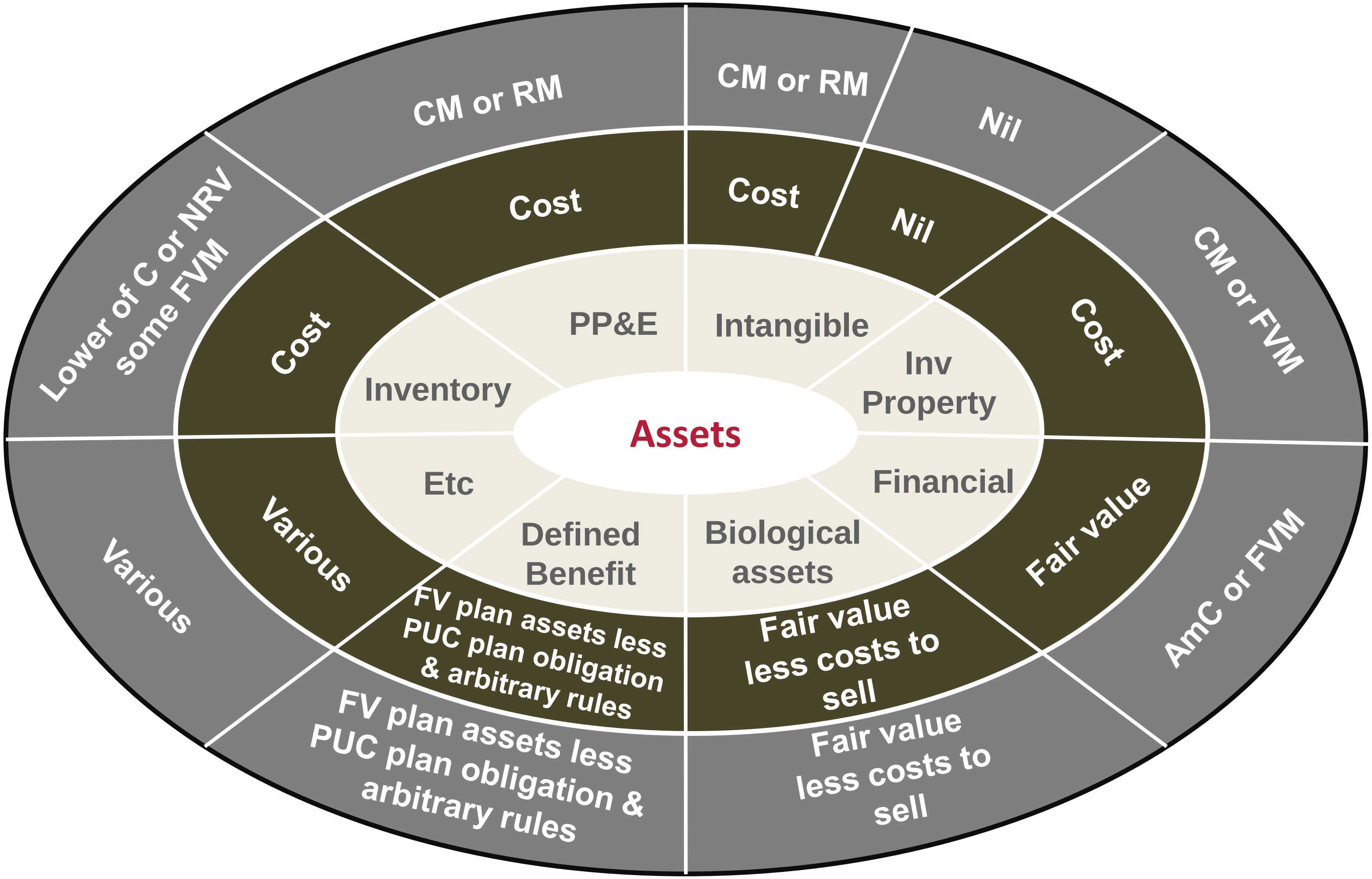
IFRS 13: Background

- IFRS 13: Fair Value Measurement
  - Defines fair value;
  - Sets out in a single IFRS a framework for measuring fair value; and
  - Requires disclosures about fair value measurements.

IFRS 13: When it applies



Definition of fair value

The price received to sell an asset or paid to transfer a liability in an orderly transaction in the principal market (or most advantageous market) between market participants at the measurement date

Transport costs

EXIT PRICE

Transaction costs

Definition - some remarks

- Fair value is the price that would be received to sell an asset or paid to transfer a liability **(exit price)** in an orderly transaction **(not a forced sale)** between market participants **(market-based view)** at the measurement date **(current price)**.
- Fair value is a market-based measurement **(it is not an entity-specific measurement)**
- Consequently, the entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

Key Considerations

Step 1: What is the unit of account?

Step 2: Is there more than one market for the item?

Step 3: Who are the other market participants?

How would they use the asset/liability?

Step 4: What is the current use of the asset?

Is there a better alternative use for the asset?

Step 5: Calculate the price

Step 6: Fair value disclosures

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.

The Transaction

Assumes transaction takes place in either:

- Principal market; or
- Most advantageous market (*if no principal market*)

The Price

Price that would be received to sell an asset or paid to transfer a liability…(i.e. an *exit price*)

- Excludes transaction costs
- Consider highest and best use for non-financial assets

Orderly Transaction

<u>Orderly</u> transaction…at the measurement date

- Assumes exposure to market prior to measurement date
- Not a forced transaction

Market participants

Buyers or sellers in principal market that are:

- Independent
- Knowledgeable
- Willing and able to transact

Principal Market vs Most Advantageous Market

- Fair value measurement assumes that the transactions to sell the asset or transfer the liability takes place in the *principal market.*

- The *principal market* is the market with the greatest volume and level of activity.

- If there is no principal market, then the transaction is assumed to take place in the *most advantageous market.*

- The *most advantageous market* is the market that either maximizes the amount that would be received to sell the asset, or minimizes the amount that would be paid to transfer the liability after taking into account transaction costs and transport costs.

Fair value measurement

Market Approach

- The market for identical or similar assets and liabilities or group of assets and liabilities such as a business

Example Techniques

- **The fair value of an investment in listed shares is determined by reference to the listed share price**
- **The fair value of land is determined by reference to other pieces of land in a nearby location with similar attributes**

Income approach

- The income approach converts future amounts such as cash flows or income streams, to a current amount at the measurement date.

Example Techniques

- **Discounted cash flow method-**the fair value of an investment property is measured by discounting expected cash inflows and outflows arising from the property at the rate of return that investors in the property will require.
- **Multi period excess earning method-** the fair value of an intangible asset is based on the cash flows attributable to the asset after deducting the cash flows attributable to other assets of the business(contributory assets)

Cost approach

- The cost approach seeks to reflect the amount that will be required to replace the service capacity of a non-financial asset.

Example Techniques

- **Depreciated replacement cost-** The fair value of a specialized plant is based on how much it will cost to reproduce a plant of equivalent utility taking into account physical, functional and economic obsolescence

Valuation techniques

Using valuation techniques

- When a quoted price for an identical asset or liability in an active market is not available
- Maximize the use of observable inputs
- Minimize the use of unobservable inputs

Fair value hierarchy

Level 1	Level 2	Level 3
Unadjusted quoted prices for identical instruments in active market	• Quoted prices for similar instruments in active market • Quoted prices for similar/identical instruments in non active market • Observable inputs and insignificant unobservable inputs	Significant unobservable inputs

Definition - concluding remarks

- Fair value is the price that would be received to sell an asset or paid to transfer a liability **(exit price)** in an orderly transaction **(not a forced sale)** between market participants **(market-based view)** at the measurement date **(current price)**.
- Fair value is a market-based measurement **(it is not an entity-specific measurement)**
- Consequently, the entity's intention to hold an asset or to settle or otherwise fulfil a liability is not relevant when measuring fair value.

Disclosure

- Information about an entity's valuation processes is required for fair value measurements categorised within Level 3 of the fair value hierarchy.
- A narrative discussion is required about the sensitivity of a fair value measurement categorised within Level 3.
- Quantitative sensitivity analysis is required for financial instruments measured at fair value.

Judgement and estimates

- An entity must take all information that is reasonably available to search for a principal market.
- determining fair value and the highest and best-use.for a non-financial asset.
- Assumptions that a market participant would use (including assumptions about risk).

Judgement and estimates

- Determining the correct valuation technique to use and the inputs to the techniques, particularly on the income approach, require a wide range of estimates as:
  - Discount rates
  - Future cash flows
  - Risks and uncertainty

Judgement and estimates ….

- The inputs used in the valuation techniques should primarily be based on observable inputs (where possible) to minimize the use of unobservable inputs.

Key points to remember

1. Fair value is the exit price
2. Consider assumptions that other market participants would use
3. Highest and best use of a non-financial asset should be consistent with a market participant’s view
4. Use valuation technique that maximizes use of observable inputs
5. Disclose valuation processes for Level 3

IAS 8: Accounting Policies, Changes in Accounting Estimates and Errors

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Accounting policies

- **Accounting policies**
  - Specific principles, bases, conventions, rules and practices applied by an entity in preparing and presenting financial statements

Selection of accounting policies

- **Accounting policy determined by**
  - Applying a specific IFRS
  - Considering any relevant implementation guidance

- **In absence of a specific IFRS**
  - Use judgement to develop an accounting policy that results in relevant and reliable information
    I. First, refer to IFRSs dealing with similar and related issues and second, to framework; and
    II. Consider pronouncement of other setters or industry practices if consistent with above

Consistency in applying accounting policies

- Select and apply accounting policy consistently for similar transactions, other events and conditions

- May adopt different policies
  - When an IFRS requires or permits categorisation of items for which different policies may be appropriate
  - But accounting policy selected and applied should be consistent to each category

Disclosure – judgement and estimation

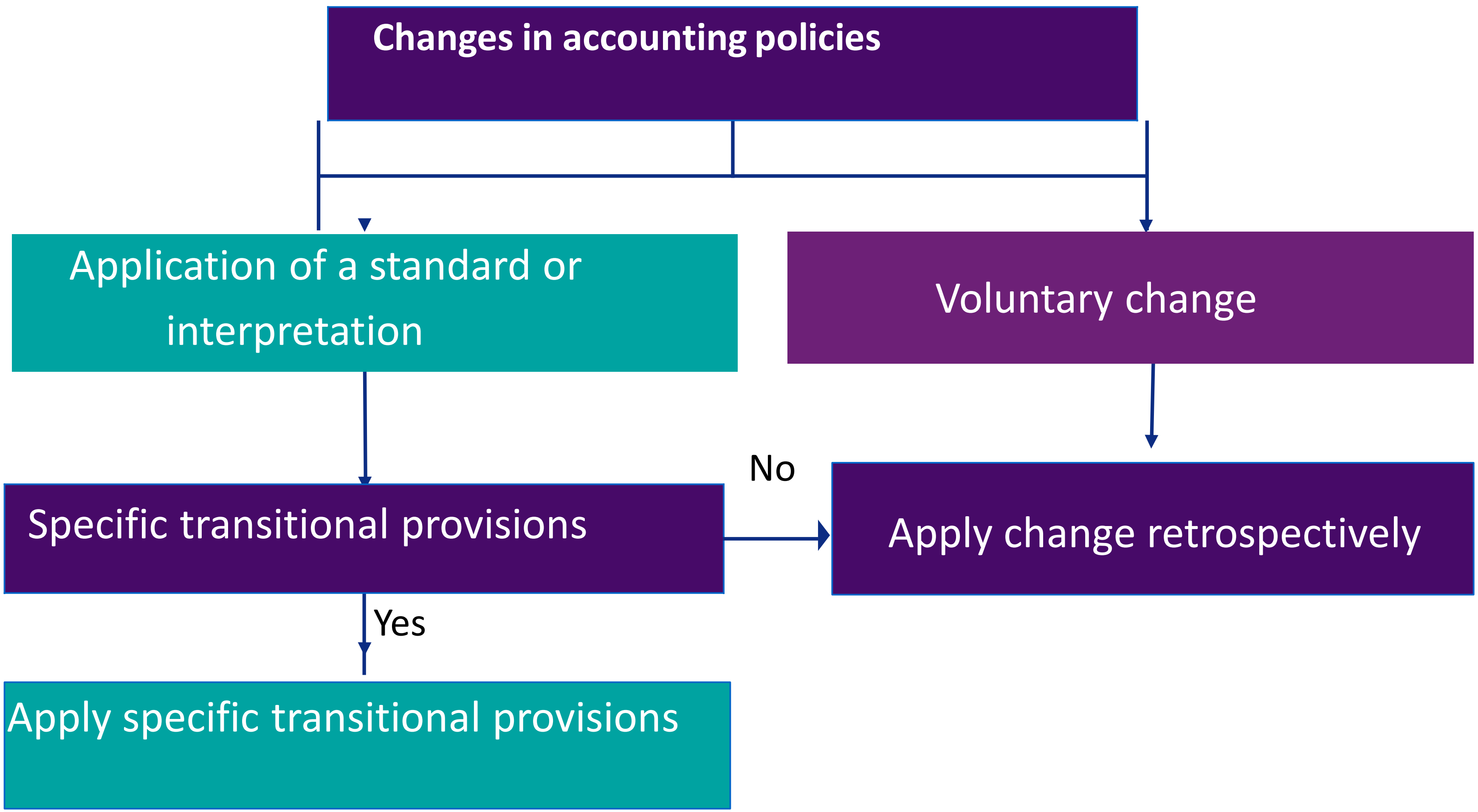
- **Disclose the judgements made by management**
  - that have the most significant effect

- **Disclose information about key assumptions**
  - concerning the future, and other key sources of estimation uncertainty
  - disclose for those assets and liabilities
    I. their nature; and
    II. their carrying amount at the end of the reporting period

Change of accounting policies

- Consistency is important
- Change an accounting policy only if the change:
  - is required by an IFRS; or
  - results in the financial statements providing reliable and more relevant information

Applying changes in accounting policies



Applying changes in accounting policies

Uphold Public Interest

Retrospective application is impracticable

Period-specific effects

Cumulative effect at the beginning of the current period

Apply new accounting policy as at the beginning of the earliest period for which retrospective application is practicable

Financial statements are adjusted as at the beginning of the earliest period from which retrospective adjustment is practicable

Retrospective application

- **Use only information that**
  - Provides evidence of circumstances at the time; and
  - Would have been available when the financial statements of that period were authorised for issue (No hindsight)

- **If a significant estimate requires the use of information that does not meet these criteria then**
  - Retrospective application is impracticable

- **No hindsight in estimates**

Changes in accounting policies - disclosure

- **When an entity restates, IAS 1 requires an entity to prepare an additional statement of financial position as at the beginning of the comparative period**
- **When <u>initial application</u> of a standard or an interpretation has an effect, disclose**
  - Change in accordance with transitional provisions
  - For current period and each prior period presented the amount of the adjustment for each financial line item affected and for basic and diluted earnings per share, if IAS 33 applies
  - The amount of the adjustment relating to periods before those presented, to the extent practicable
  - If retrospective application is required but impracticable, the circumstances and a description
- **Need not repeat these disclosures in subsequent periods**

Changes in accounting policies – disclosure…

- **When a <u>voluntary change</u>:**
  - Has an effect on the current period or any prior period
  - Would have such an effect except that it is impracticable to determine the amount of the adjustment; or
  - Might have an effect on future periods
- **Then we are required to disclose:**
  - Why the change provides reliable and more relevant information
  - For current period and each prior period presented the amount of the adjustment for each line item affected
  - The amount of the adjustment relating to periods before
  - those presented
  - If retrospective application is impracticable, the circumstances and a description
- **Need not repeat these disclosures in subsequent periods**

Changes in accounting policies – disclosure…

- **When <u>not applying a new</u> IFRS that has been issued but is not yet effective, disclose**
  - This fact
  - Known or reasonably estimable information relevant to assessing the possible impact that application of the new IFRS will have on the financial statements in the period of initial application

Changes in estimates

- **Include the effect of a change in an accounting estimate in net profit or loss in**
  - The period of the change, if the change affects the period only, or
  - The period of the change and future periods, if the change affects both
- **If difficult to distinguish between change in accounting estimate and in accounting policy**
  - Treat the change as a change in accounting estimate

Changes in estimates

- **Disclose the nature and amount of a change in an estimate:**
  - That has an effect in the current period, or
  - Is expected to have an effect in the future periods
- **If impracticable to quantify the amount, disclose that fact**

Prior period errors

- **Errors in respect of recognition, measurement, presentation or disclosure**
- **Prior period errors**
  - Omission and misstatements for one or more prior periods arising from a failure to use, or misuse of, reliable information
- **Such errors include**
  - The effects of mathematical mistakes in applying accounting policies
  - Oversights or misinterpretations of facts
  - Fraud

Prior period errors

- **Correct <u>material</u> prior period errors retrospectively in the first set of financial statements authorised for issue after discovery by:**
  - Restating the comparative amounts for the prior period presented in which the error occurred; or
  - If the error occurred before the earliest prior period presented, restating the opening balances for the earliest prior period presented

Prior period errors

Retrospective application is impracticable

Period-specific effects

Cumulative effect at the beginning of the current

Restate the opening balances of assets and liabilities and equity for the earliest period for which retrospective restatement is practicable

Restate comparative information to correct the error prospectively from the earliest date practicable

Prior period errors

- When an entity restates, IAS 1 requires an entity to prepare an additional statement of financial position as at the beginning of the comparative period
- Extensive disclose requirements
  - Disclose the nature of the prior period error
  - For each prior period presented the amount of the correction
  - The amount of the correction at the beginning of the earliest prior period presented
  - If retrospective restatement is impracticable, the circumstances
    - that led to the existence of that condition and a description of how and from when the error has been corrected
- Need not repeat these disclosures in subsequent periods

Questions & comments

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