

Principles and the Use of Judgment in IFRS

World Bank Centre for Financial Reporting Reform
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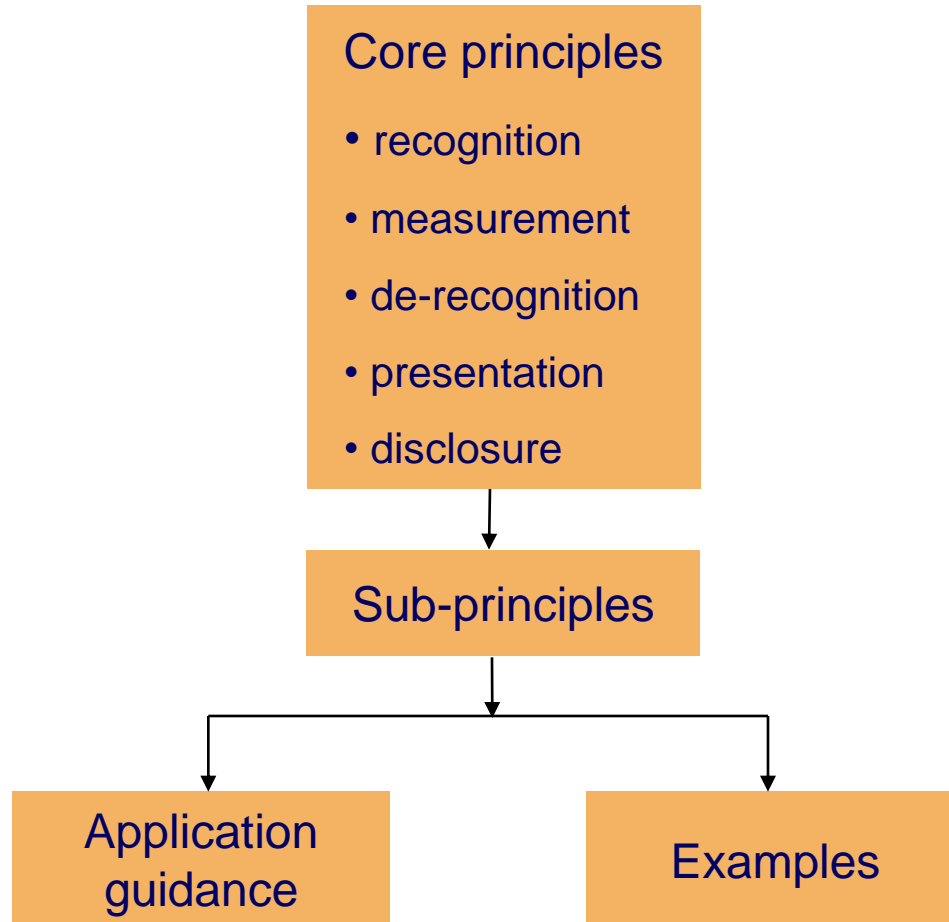
Use of Judgement

- National GAAP and IFRS require the use of judgement to decide:
 - which requirements apply to a transaction, other event or circumstance
 - how to apply those requirements to that transaction, other event or circumstance

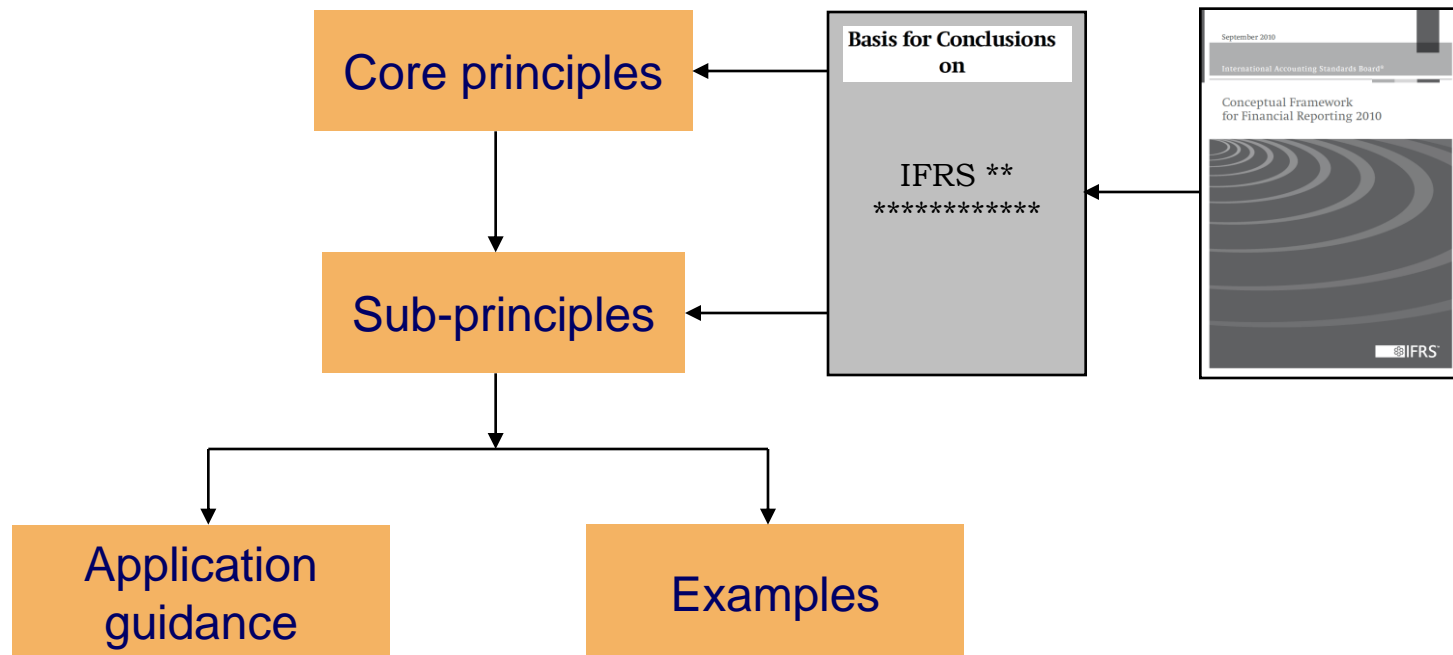
Use of Judgement

- Both national GAAP and IFRS require the use of judgement to decide, for example
 - how to account for receipt of €1,000,000
 - how to account for contract to pay EUR500,000/receive USD700,000 in one month's time
 - whether to consolidate another entity

Principles-based Standards



IFRS as Principles-based Standards



Consolidated Financial Statements (IFRS 10)

Core principle: control

Exposure to, or rights to,
variable returns from
involvement with investee

+

Ability to affect the
investee's returns through
power over the investee

Applying the Principle of Control (IFRS 10)

- Entity A:
 - owns 100% of the equity capital in entity S
 - exercises all the voting rights in entity S
 - uses those rights to appoint the directors of entity S who direct the activities that significantly affect entity S's returns and, hence, the returns to entity A
- Use judgement to decide whether
 - entity A is exposed to, or has rights to, variable returns from involvement with entity S
 - entity A has the ability to affect entity S's returns through power over entity S

Applying the Principle of Control (IFRS 10)

- Entity A and entity B each:
 - own 50% of the equity capital in entity S
 - exercise 50% of the voting rights in entity S
- Entities A and B enter into a contractual agreement under which
 - entity A appoints the board of directors of entity S who direct the activities that significantly affect entity S's returns and, hence, the returns to entities A and B
- Use judgement to decide whether
 - entity A and/or entity B is exposed to, or has rights to, variable returns from involvement with entity S
 - entity A or entity B has the ability to affect entity S's returns through power over entity S

Applying the Principle of Control (IFRS 10)

- Entity A:
 - owns 43% of the equity capital in entity S
 - exercises 43% of the voting rights in entity S
 - in practice, appoints the board of directors of entity S who direct the relevant activities that significantly affect entity S's returns and, hence, the returns to entity A and other holders of equity capital
- The remaining 57% of the equity capital in entity S is widely held - there are no contractual arrangements between any shareholders.
- Use judgement to decide whether
 - entity A is exposed to, or has rights to, variable returns from involvement with entity S
 - entity A has the ability to affect entity S's returns through power over entity S

IFRS Asset Measurement

Cost model



Historical cost
less any subsequent
depreciation,
amortisation and
impairment losses

Fair value model



Fair value
at date of financial
position

Asset Measurement

Different Judgments for Different Models

Cost Model

Manufactured inventories (IAS 2)

Use judgement to determine:

- costs of purchase
- costs of conversion including fixed and variable production overheads
- other costs including borrowing costs
- impairments

Fair Value Model

Unlisted equity instrument (IFRS 9)

Use judgement to determine:

- valuation technique
- inputs to valuation technique
- principal or most advantageous market
- market participants

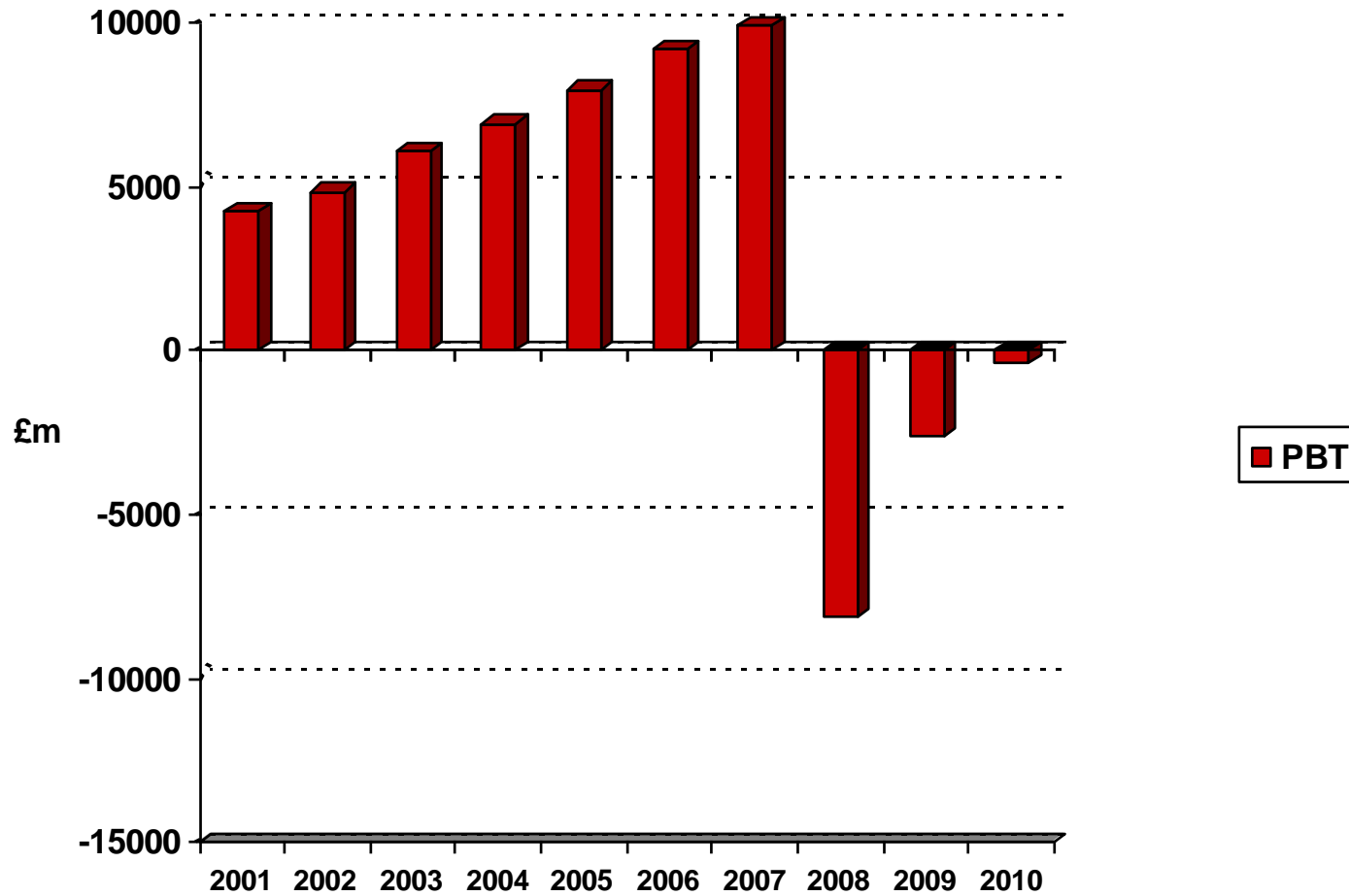
Selection of Accounting Policy

Bank R is required by national law to prepare IFRS financial statements.

Bank R is also required by the Central Bank to maintain financial stability by adjusting its loan impairments in order to smooth its reported profits.

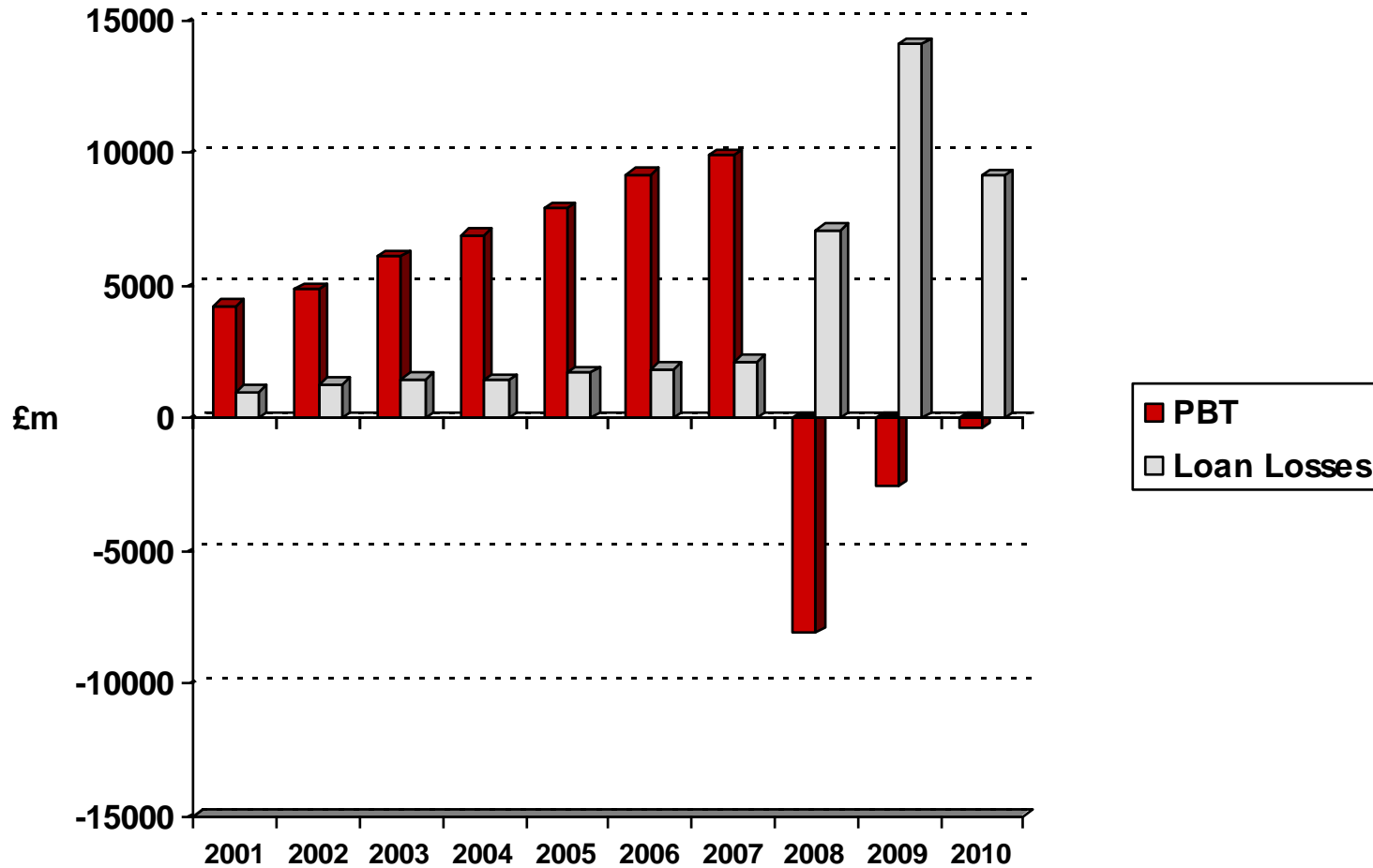
Bank R

IFRS Profits Before Tax



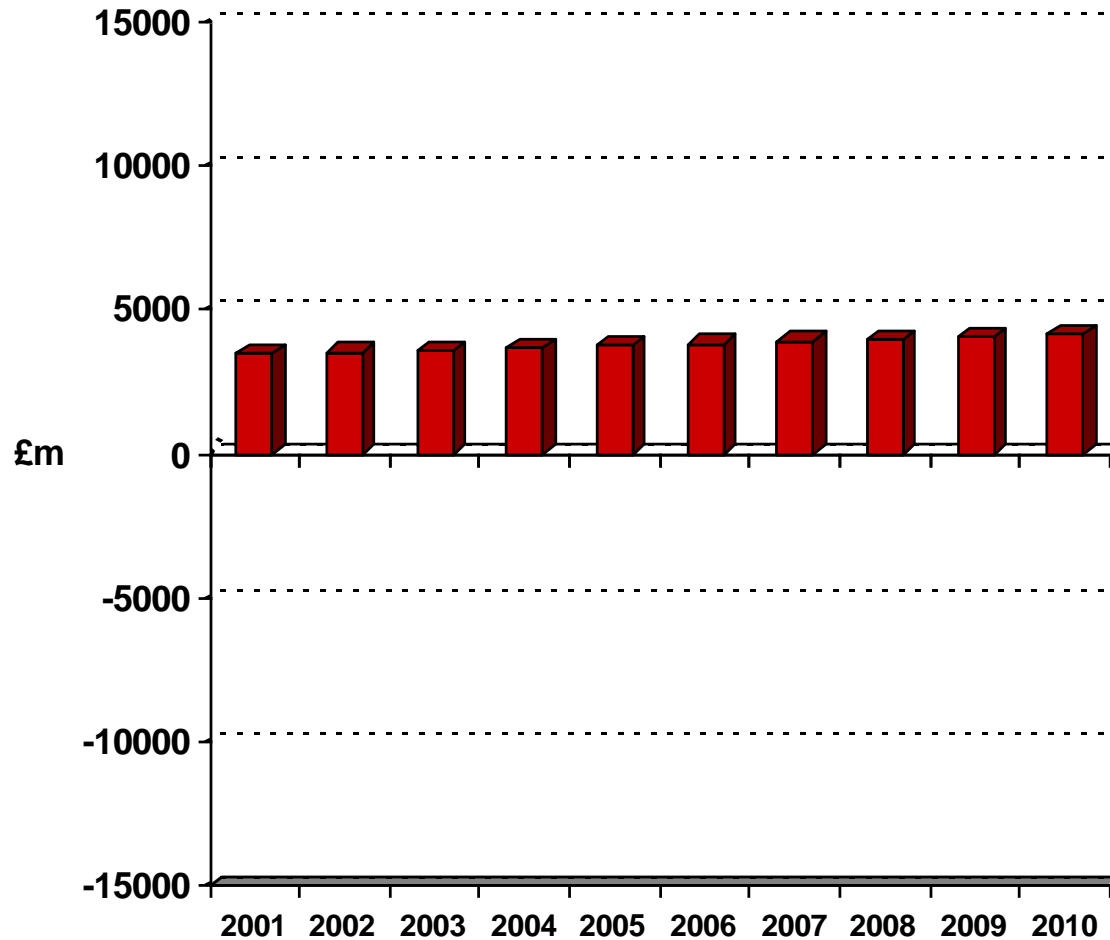
Bank R

IFRS Impairment Losses and IFRS Profits Before Tax



Bank R

Profit Before Tax (Central Bank)



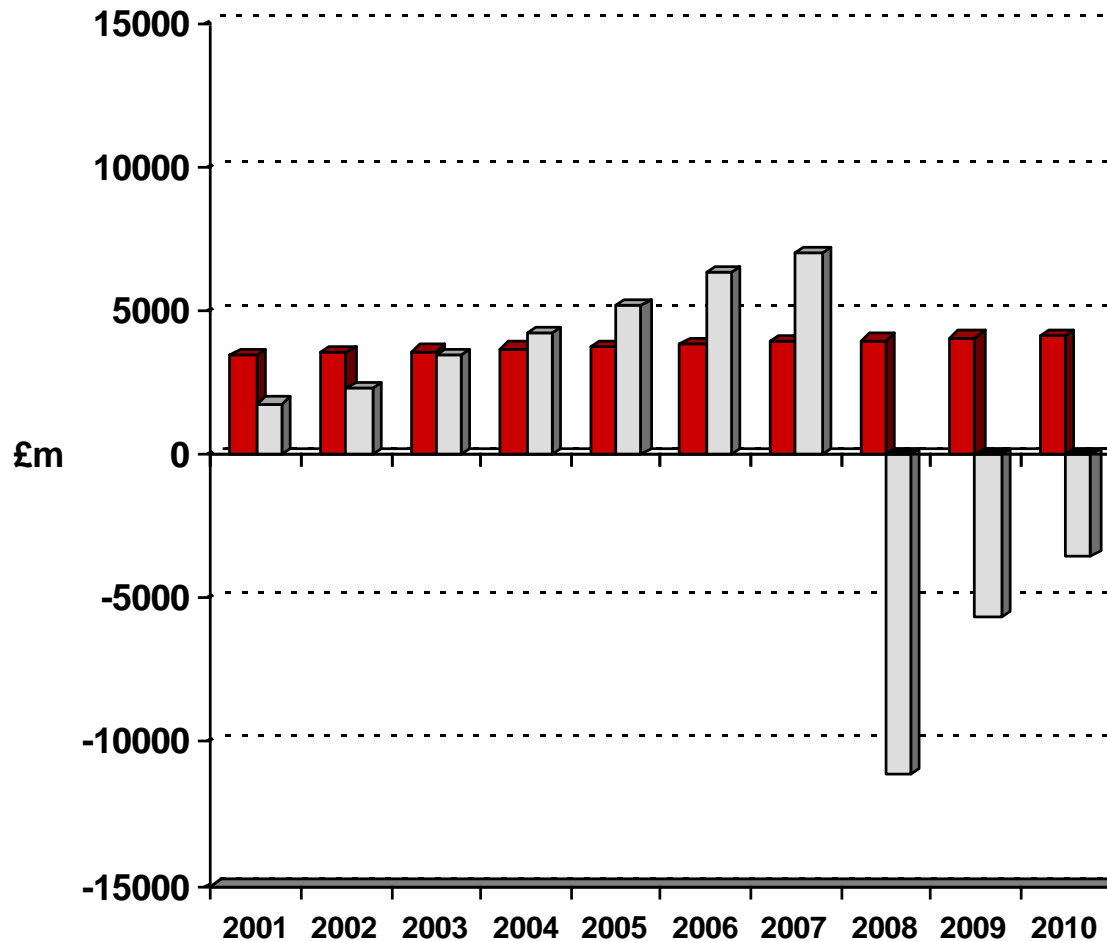
Assumption:

IFRS profit before tax for ten years spread on basis of 2% growth pa in PBT

■ PBT

Bank R

Impairment Losses and Profit Before Tax (Central Bank)



Assumptions:

IFRS profit before tax for ten years spread on basis of 2% growth pa in PBT. Profits smoothed by [undisclosed] adjustments to provisions for loan impairments and hence to impairment losses charged to profit and loss



Selection of Accounting Policy

Bank R is required by national law to prepare IFRS financial statements.

Bank R is also required by the Central Bank to maintain financial stability by adjusting its loan impairments in order to smooth its reported profits.

- Use judgement to determine accounting policy for loan impairments in bank R's IFRS financial statements
 - apply IAS 8 hierarchy
 - use national requirements only if
 - no IFRS/interpretation on issue
 - national requirements issued by national body with similar conceptual framework and
 - national requirements do not conflict with related IFRS/interpretation/
Framework

IASB/IFRIC Approach

Judgement, not Interpretations

- Entity A is required by law to share 10% of taxable profit with employees
- IFRIC declined to issue interpretation on this issue because IAS 19 provides sufficient guidance
 - event profit share is consideration paid by entity in exchange for employee service
 - entity A should recognise liability/employee benefit expense when it has present legal or constructive obligation to make profit share payment as a result of a past

US GAAP Approach

Sector-specific Interpretations

- Entity A provides health care to individuals but is uncertain about the collection of revenue
- EITF (USA) issued interpretation on revenue recognition for health care providers
 - requirements may differ from requirements for revenue recognition in other sectors

IASB/IFRIC Approach

Judgement, not Interpretations

- Entity A is required provides health care to individuals but is uncertain about the collection of revenue
- IFRIC would probably decline to issue interpretation because IAS 18 provides sufficient guidance
 - provision of health care is service giving rise to revenue
 - entity A should recognise revenue by reference to stage of completion but only when it is probable that economic benefits will flow to entity A
 - entity A and its auditors should use judgement to apply these principles in cases of uncertainty

Principles and the Use of Judgement

Implications for IFRS Training

- Teach an understanding of:
 - the objectives of IFRS financial statements
 - how those objectives are reflected in the concepts in the *Conceptual Framework*
 - how those concepts are reflected as core principles in IFRS
- Teach the ability to:
 - apply IFRS principles in circumstances likely to be encountered in practice
 - exercise judgement, rather than seek interpretations and other formal guidance from the IASB/IFRIC/national bodies
 - make estimates that reflect the underlying economics

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