Principles and the Use of Judgment in IFRS

World Bank Centre for Financial Reporting Reform
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David Cairns
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
Core principles

- recognition
- measurement
- de-recognition
- presentation
- disclosure

Sub-principles

Application guidance

Examples
IFRS as Principles-based Standards

Core principles

Sub-principles

Application guidance

Examples

Basis for Conclusions on

IFRS **

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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)

<table>
<thead>
<tr>
<th>Entity A:</th>
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<tbody>
<tr>
<td>- owns 100% of the equity capital in entity S</td>
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<tr>
<td>- exercises all the voting rights in entity S</td>
</tr>
<tr>
<td>- 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</td>
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- 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

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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

\[ \text{Historical cost} \]
less any subsequent depreciation, amortisation and impairment losses

Fair value model

\[ \text{Fair value} \]
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
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
Profit Before Tax (Central Bank)

Assumption:
IFRS profit before tax for ten years spread on basis of 2% growth pa in PBT
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.
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 to provide 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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