P2 – JUNE 2013 REVISION & PRACTICE TASK LIST

IFRS	QUESTIONS	NOTES
IFRS 5		
1. Revalued NCA – what happens to the revalued surplus/deficit on classification as *held for sale*?		- Revaluation surplus/deficit should be released to Retained earnings on classification as held for sale. -
2. Include CS 6 p497-8 in WKB		
3. Reclassify from held to sale – accounting entries		
4. Review workbook		
IFRS 13		
1. Rehearse principles 2. Review E&Y for valuation exercises (market, income, cost) 3. Design exercises to apply principles & explore problems 20/04/2013 4. Design worksheets for **Application to non-financial assets** E&Y 1018 5. Issues to cover in exercises designed for June 2013: - Valuation techniques: market, income, cost - Level 1& 2 **adjustments** (types) - Level 3 inputs E&Y p1069 16.5	**Expect more questions in June & December 2013 because December 2012 was woeful.** **Review June & December 2012 predictions** - Follow up remaining issues not yet examined - Add graded practice exercises to workbook - Focus on q1, 2, 3 type questions.	KEY PRINCIPLES (THE FAIR VALUE HIERARCHY) i) Fair value is focused on the assumptions of the market place and is not entity specific. ii) The fair value must reflect the assumptions of market participants and their perceptions of the characteristics of the asset or liability (fair value is determined from the perspective of market participants) iii) Fair value is an exit price notwithstanding that the inputs may originate from the entity as in the case of level 3 unobservable inputs. iv) The characteristic of the asset or liability must be distinguished from a characteristic of holding the asset or liability. An example is where the holder of a large portfolio of shares sells his holding at a discount to the market price. The discount is an example of a characteristic that is not inherent in the shares - it arises from the holding of the shares and should therefore not affect the fair valuation of the shares. By contrast the credit rating of the issuer of a bond is a characteristic inherent in the quality of the bond, and where the credit rating of the issuer significantly deteriorates the value of the bond correspondingly deteriorates, resulting in higher interest rates to compensate market participants and this is reflected in a decline in bond prices. v) Current market conditions must ensure that a) the entity can enter the market immediately and sell the asset or transfer the liability in its current form at the measurement date; b) there is an active market adequate to ensure sufficient frequency and volume of trading to generate market prices on an ongoing basis; c) information is freely available to all market participants to ensure that the asset or liability has adequate marketing exposure to generate sufficient competitive interest that is normal practice in this type of market; d) market participants are knowledgeable and willing to enter into transactions freely vi) The market is assumed to be the principal or, if no principal market, the most advantageous market. The principal market is where the entity can trade the asset or

- Inputs to valuation model for non-financial assets (discussion of various issues and related principles e.g. liabilities without a corresponding asset, implications of changes to credit rating, valuation premise, unity of account, disclosure, premium, discount, transaction costs) - Explain significance of levels - Disclosures (recurring and non-recurring) - Compare the application of IFRS 13 to IFRS 1, IAS 38, IFRS 3, IAS 16, IAS 40, IFRS 2, IFRS 9 (discuss recognition and measurement inconsistencies and what this means for convergence. Does convergence produce comparability?) - Be able to discuss an asset's valuation and classification through the levels e.g. when might real estate as IAS 16 or as IAS 40 be appropriately classified as levels 1, 2 or 3? - **Adjustments** to		liability at the highest volume and level of activity. The most advantageous market is where the entity can maximise the amount that can be received to sell the asset or minimises the amount that can be paid to transfer the asset net of transport and transaction costs. vii) Transport costs are relevant only if location is a factor in determining the fair value of the asset that is, moving the asset to the principal or most advantageous market. These may be deducted from the fair value. viii) Transaction costs are not relevant to fair value because they are not inherent to the asset's value – they are a market cost. ix) The unit of account is the single asset (or liability) or group of assets (or liabilities) to be sold or transferred together as a unit, as in IFRS 5 disposal group. The unit of account is not prescribed by IFRS 13 in keeping with the principles-based practice of the IASB. The unit of account is determined by management for each IFRS that requires fair value. x) Valuation techniques can be based on market, income or cost. **KEY PRINCIPLES OF THE FAIR VALUE HIERARCHY** The fair value hierarchy is a concept that reflects how the IASB prioritises inputs to valuation techniques used to determine fair value based on their relevance – relevance being driven by the exit price determined at the measurement date. The further away the input is from this ideal the lower it is down the hierarchy and the less of it should be used in the determination of fair value. The purpose of this hierarchy is to make fair valuation transparent such that the user of financial statements can evaluate the quality of the inputs on which fair value depends and make decisions based on relevant information about fair values and the sensitivity of fair values to related inputs and assumptions. Each **fair value measurement** is categorised in its entirety based on the lowest level input that is significant to the **entire measurement**. These criteria make for consistency and comparability between amounts in financial statements. **Level 1 (See 16.3 p1065)** **Level 1** input is an unadjusted quoted price in an active market of an item that is identical to the asset or liability to be measured. The price is assumed to be the exit price at the measurement date. Alternative methods can be allowed where the price is not fair value. This would be the case where a significant event occurs immediately after the measurement date that significantly affects future earnings potential. An example of such an event is a reorganisation, acquisition or merger. **Level 2**

"**observable data**" based on "**unobservable data**" e.g. see E&Y p1069 16.4.2 - **Adjustments** (see Example 16.17) **p1044**: develop examples to do the calculations. - When are inputs to value equity categorised as L1, 2, 3? - Evaluate inputs under each of the fair value hierarchy for valuation of i) reacquired rights, ii) brands, iii) goodwill, iv) property, etc. (Refer to E &Y - 6.		**Level 2** inputs are all observable (confirmed by completed trade or other market activity) inputs except those of level 1. These are (direct) fair values of assets and liabilities similar to the assets and liabilities to be measured or indirect inputs supporting calculations of fair value. An example of a level 2 input used to determine fair values is in **split accounting** to account for the acquisition cost of a convertible bond. The fair value of the liability component is determined by the PV method using interest rates receivable on an equivalent plain vanilla bond. **ACQUITION COST = FAIR VALUE OF LIABILITY + EQUITY** Note that where fair value is not available PV is used as in **split accounting** as an approximation of fair value using level 2 input (interest rates). **Level 3** These are unobservable inputs (not confirmed by contract, transaction or other means) and their use should be kept to a minimum – only use where there are no relevant suitable observable substitutes. Where required inputs are not observable relevant unobservable inputs (e.g. internally generated cash flows from investment projects discounted at suitable discount rates to reflect risk) must be developed to reflect the assumptions that market participants would use when determining the fair value of the asset or liability in an active market on the measurement date. Application examples: - See E&Y p1028 - See E&Y p1003, Fig 16.2 - See E&Y p1060 APPLICATION TO LIABILITIES AND THE ENTITY'S OWN EQUITY INSTRUMENTS Focus notes - Classification of financial instruments between equity and financial liability - Split accounting for liabilities IFRS 9 (use of Level 2 inputs – interest rates on similar plain vanilla bond) - Split accounting IAS 32 VALUATION PREMISE IFRS 13 requires a non-financial asset to be valued on the basis of its **highest and best use**. The highest and best use of a non-financial asset is the use by market participants that would maximise the value of the asset or group of assets and liabilities with which it is used.

		The **valuation premise** is the market participant's assumption about the highest and best use of the non-financial asset. This assumption is crucial to the determination of the fair value of the non-financial asset. If the valuation premise is that the highest and best use of the asset is as a standalone asset, then its fair value would be measured on that basis. If on the other hand the valuation premise is that the highest and best use of the asset is in combination with other *complementary* assets and liabilities (e.g. buying a business entails taking on the pension liabilities and assets, share-based payment obligations, etc.) then the value of the asset would be determined by reference to its use within the combined entity. If the business is valued without the pension and other staff related obligations then the business would be valued differently and it may not be the same business because certain key personnel may find lack of a pension too much to bear and could leave with significant consequences for the business. HIGHEST AND BEST USE *When the use of the asset by the entity differs from that of market participants* Measuring the fair value of an asset when market prices are <u>not</u> available is more challenging when the entity's use of the asset (including defensive use) differs from that of market participants. Why is that? Inputs to the valuation model in such circumstances would be *particularly* difficult to validate as the assumptions (of market participants) that underly them cannot be substantiated by market prices (**market approach**) business plans (**income approach**) or operational plans (**cost approach**). (Judgement is required to evaluate methods that would provide reasonable fair values consistent with the unit of account, valuation premise and conceptual framework) Discuss scenarios where a) Asset is specialised (fair value would be lowered to be able to sell the asset for scrap or for use not specifically anticipated when the asset was developed) b) Asset is not specialised When the asset is specialised i.e. the asset or group of assets has specialised application Presumptions about the highest and best use of an asset can determine selection of the most appropriate valuation technique that would produce the *most representative measure* of fair value. For example, for a specialised tangible asset the highest and best use of the asset is in its specialised application in combination with other assets or liabilities or group of assets or liabilities. The **market approach** is unlikely to be used in the valuation of a specialised asset because there are no comparable alternative uses for the asset for which market prices would be available. Such an asset would be sold on a standalone basis only in the event of business failure - at scrap value or at significantly reduced value in use corresponding to lesser-function uses.

		The **market approach** can be used in the valuation of a non-specialised asset because such an asset has a variety of uses and prices that are unlikely to vary significantly within a certain range. Thus switching uses is unlikely to result in significant price changes and decline in value. The **income approach** is not normally used in the valuation of tangible assets because excess returns expected on projected cash flows are attributed to **intangible** *operating assets* such as goodwill and brands rather than to tangible noncurrent assets. Furthermore, specialised assets being used in combination with other complementary assets can hardly be attributed separate, identifiable income streams that can used to project reliable estimates of future cash flows as a basis for fair value measurement. This leaves the **cost approach** as the only reliable valuation technique that would produce the most representative of fair value measures for a specialised asset. Workbook exercises IMPAIRMENT OF ASSETS IFRS 13 has the following impacts i) The standard clarifies that **value-in-use** is not fair value and should not be used as a proxy. This clarification is inserted into IAS 36. ii) The standard *amends* the disclosure requirements when fair value less costs to sell is used as a measure of **recoverable amount**. The amendments relate to i) the level of the fair value measure within the hierarchy; ii) the valuation technique used (including disclosure of any changes from the previous valuation prior to IFRS 13 and the reasons for it); iii) whether the fair value measurements are *recurring* or *non-recurring*. These disclosures would need to be made regardless of whether the asset is impaired and so would need to be made even if the carrying amount is not reflective of fair value less costs to sell. iii)
	Exam practice	Issues	
		Principles	
		Exercises	

Issue	Principle	Analysis and resolution
Aquired brand is withdrawn from use on the	The fair value of the brand would be	The *most representative measure* of **fair value** is the measure that reflects

assumption that its removal would generate greater incremental value to the acquiring entity as a result of increased revenues from existing brands.	determined from market participant's perspective and is not influenced by the individual entity's decision.	market **participants' assumptions** about the *most salient characteristics* of the brand. Accordingly, the fair value of the brand is the **maximum incremental value to market participants**. This represents the price that would be received to sell the brand in its current condition on the assumption that the market participant has **complementary assets** and **liabilities** with which the brand would be used to obtain its *highest and best use*. However, the fair value measurement assumes that the asset is sold based on a **unit of account** that is consistent with that specified in IAS 38 *Intangible assets*. **Question:** is this *basis of measurement* compatible with the **Conceptual Framework** definition and recognition of an asset? The Conceptual Framework (CF) sets out three guidelines for determining whether or not an asset should be recognised: i) The **benefit** (which the definition refers to) can be separated from the **source** (a right e.g. brand IAS38 or an object e.g. land, the resource). Thus the value derived from the brand by market participants is separate from the (defensive) value derived by the acquiring entity in the example above. Thus CF does not stand in the way of fair value determination being a constructivist concept designed to reflect certain value expectations given certain conditions: (current market conditions at the measurement date). See KPMG illustration of highest and best use. Open link to download spreadsheet in Workbook supplement column. ii) The **existence of exchange value** is not a prerequisite for the recognition of an asset (*Thus idle, obsolete, unique, damaged assets can be recognised*). In this case the **exit price** is the object of the measurement and therefore there is no issue. iii) **Legal enforceability** is not essential for an asset to be recognised. The assumption of a *hypothetical transaction* involving market participants that have no legal rights is therefore not precluded. **EXERCISES**
Fair valuation of specialised assets.	The same principles apply – the specialised asset is fair valued from the market participant's perspective. The asset must be specified together with the related unit of account (based on the measurement IFRS e.g. IAS 16). The valuation premise must be appropriate for the measurement and be compatible with the *highest and best use* expectation. The income approach is not normally used unless the asset is specialised. This is because	**REVIEW WITH CASE STUDY:** The **arguments** regarding the **relative use** of the **income approach** is not clear. E.g. why are *excess returns* relevant to fair values of unique assets? Is it because they may as a result of subjectivity be more susceptible to error? Why are *excess returns* not normally attributed to tangible operating assets but to intangible ones?

	the *excess returns* in the expected cash flows from the operation of a business are normally not attributed to the tangible assets but to the intangible ones such as **goodwill** and **brands** – known as *operating assets*. The operating tangible assets get lower priority after the intangible ones unless they are specialised operating assets.	

Highest and best use v intended use		
An entity acquires a research and development (R&D) project in a business combination. The entity does not intend to complete the project because if completed the product would complete with one of its own products to provide the next generation of mobile phones. Instead, the entity intends to hold (lock up) the project to prevent its competitors from obtaining access to the technology. In doing this the project is expected to provide defensive value, principally by improving the prospects for the entity's own competing technology. To measure the fair value of the project in accordance with IFRS 13 the highest and best use of the project would be determined on the basis of use by market participants. Possible scenarios are analysed below.		
Continue development	**Cease development**	**Cease development**
The *highest and best use* of the R&D project is to continue development if market participants would continue its development	The *highest and best use* of the R&D project is to cease development if market participants would, for competitive reasons, lock up the project	The highest and best use of the R&D project would be to cease development if market participants would discontinue its development.
… and that use will maximise the value of the group of assets or assets and liabilities with which the project will be used i.e. the project will be used in combination with other assets and liabilities	…and that use would maximise the value of the group of assets or assets and liabilities in which the project would be used.	
That might be the case if market participants do not have similar technology at an advanced stage of development or as a product in the market with which the new technology would compete.	That might be the case if market participants have similar technology in development or in the market that would compete with the project if completed and the project would be expected to improve the prospects of their own competing technology if locked up.	That might be the case if the project is not expected to generate a market return on completion and it would not otherwise provide defensive value if locked up.
The fair value of the project would be the amount that would be received in a current transaction (at the measurement date) to sell the project assuming R&D will be used with its complementary assets and that market participants would have access to complementary assets or assets and liabilities with which the project would be used.	The fair value of the project would be measured on the basis of the price that would be received in a current transaction to sell the project assuming that R&D would be used (locked up) with its **complementary assets** and **associated liabilities** and that those assets and liabilities would be available to market participants.	The fair value of the project would be the price that would be received to sell the project **on its own** in a current transaction (at the measurement date). This might be zero.
Fair value is direct incremental value €12m	Fair value is indirect – entity's revenue grows by €15m as a result of defensive action in locking up	Fair value is zero – no body want the project that is going to lose them money.

	the project.	

Conclusion: the *highest and best use* of the project is €12m
As a market participant would continue actively using the project, the *highest and best use* of the project would be the incremental value obtained from such use regardless of whether that is less than the incremental value to the entity of withdrawing (locking up) the project from use.

10/4/2013		
Syllabus ref H		
1. Update Convergence notes	- Process ideas from **q4 June 2008** (what do these issues mean for convergence? how can they be overcome?) i) Think about reasons why despite IFRS adoption and improvements in IFRS financial statements would still fall short of the **expected qualities** of transparency, consistency and comparability. ii) What is a **financial reporting infrastructure**? iii) Why would **management judgement** play a greater role when IFRS are adopted? - Integrate green issues: how does convergence promote the green agenda? And how does the green agenda promote convergence? - Review ch6 questions for stimulus **pp248-249**	Reasons why IFRS underpinned by CF may fail to produce consistent, comparable and transparent FS - Financial reporting fraud. This can be facilitated by alternative forms of presentation (as in IAS 7- indirect method susceptible to exploitation, IAS 1); different acceptable methods of accounting (as in IAS 16, IFRS 9); lack of adequate guidance in IFRS that are open to interpretation especially under the principle-based IFRS. - IFRS 1 exemptions can have ongoing effect on financial statements e.g. - Lack of training and motivation to switch from national GAAP, especially where no CPD (unintended inconsistencies) - Lack of experience e.g. in carrying out valuations for IFRS 13 compliance could lead to inconsistent valuations - Lack of market information for IFRS 13 compliance could lead to innovative methods (hypothetical markets) acceptable under IFRS 13 - Early adoption by some and failure by others to disclose potential impact of new IFRS on initial adoption Ways to overcome divergence from the expected outcomes through the effective operation of the other elements of the **financial reporting infrastructure** - National regulators e.g. FRC (check website), PRA to provide effective enforcement and oversight mechanism - Quality of corporate governance (quality information needed to address the agency question.) - Audit quality underpinned by ISA Why greater **management judgement** may be required to implement IFRS - IFRS use *fair values* extensively; significant management judgement is required to determine the measure that is most representative of fair value; also required is a **level of expertise in valuation** techniques and **significant knowledge** about the nature and **characteristics** of the asset. - Management have to use their judgement in **selecting valuation techniques** (e.g. mathematical modelling) and in **formulating assumptions** about specific areas including

		onerous contracts, share-based payments, pensions, intangible assets acquired in business combinations and impairment of assets. (See IFRS 13 workbook exercises)
2. Design questions for **convergence practice**	- Clarify assessment objectives (AOs) - Incorporate ILs (*intellectual levels*) - Consider issues raised in June & Dec 08 - Consider issues raised in Dec 07	
3. Design workbook	-	
CF (Syllabus ref B)		
4. Integrate green issues		
5. Read and discuss B.2.a		

	IAS 38	IAS 17	IFRS 3
Definition		A lease is a contract that conveys the right to use a specified asset for an agreed period for a consideration.	"An asset representing the future economic benefits arising from other assets acquired in a business combination that is not individually identified and separately recognised." *Does goodwill meet the criteria of IFRS 13 for measuring fair value?* IFRS 13 requires "*the particular asset*" that is the subject of measurement to be determined consistently with its unit of account when measuring fair value. Goodwill as defined above does not appear to meet this criterion as it **exists only as a concept that derives its value from the net assets with which it is associated.** For example, goodwill cannot be a separate CGU. As a **residue** of the process of allocating the fair value of the **consideration** for the acquisition of a business goodwill is **not**

			directly fair valued, and some of the major components of the net assets acquired are not fair valued. From this analysis it seems that not being able to **identify goodwill** as a particular asset in its own right does not preclude it being ascribed fair value in the process of accounting for a business combination under IFRS 3. *Does goodwill meet the criteria of CF for the recognition of an asset?*
Identifiable	- Is capable of being separated from the entity and sold, transferred, licensed or rented individually or in combination with a related contract, asset or liability; or - Arises from contractual and other legal rights regardless of whether those rights are separable or transferable from other rights or obligations		Not capable of being separated from host assets from which it derives its value. The value **stems** from - **synergies** of the net assets of the business (reflecting the **unique capabilities** of the **staff** that integrated and applied the assets, systems, processes and structures) - **market imperfections** e.g. monopolistic and other factors such as barriers to entry - **contributions** of **unique capabilities** of staff that use the assets to gain competitive advantage - customer relations
Control	Relates to the power to obtain benefits from the asset and to preclude others from obtaining benefits from the same resource.	The **control condition** is an attempt to *align* the **recognition criteria** of a leased asset with the **revenue recognition** criterion developed by the joint Boards (FASB/IASB) which is based on control, i.e. the customer (in this case the lessee) must meet both requirements (direct the use of and receive benefits from the leased asset). This illustrates the benefits of the Conceptual Framework a) achieving consistency and coherence and b) efficient development of standards (linking related areas	

		e.g. revenue and leases and anticipating new standards).	
Future economic benefits			
Fair value			Fair value of the going concern element of the acquiree's existing business. Measurement issues see **613-4 E&Y Vol1** - Measure consideration accurately at acquisition date fair value taking particular care with **equity instruments** offered as **consideration**. *Where the number of equity instruments is large there would be a distortion in the fair value of the consideration if the current market price is imputed to all of the shares issued as consideration. If the shares are sold to raise cash to effect the acquisition they would be sold at a discount to the market price where the ordinary shares traded daily is small compared to the number of shares issued.* - Identify all net assets at fair value including recognizing contingent liabilities CL not recognised under IAS 37 **(E&Y p608 5.6.1A vol. 1)** (How does the proposed new definition of a liability affect this? It allows it by recognising a liability as an existing obligation on the reporting date) - Exclude previously **recognised goodwill** - Recognise **intangibles** so that they are not subsumed in goodwill. - **Reduce goodwill** for any deferred tax benefits arising in the measurement period. (**See p609 E&Y Vol 1**) - **Exceptions** certain assets and liabilities are not measured at fair value and this affects goodwill e.g. share based payments, IAS 17 leased assets. - **Overpayment** may occur where the price

			is driven up in the course of bidding for the acquiree (is this fair value?) - **Underpayment** may occur in a distress sale (certainly not *fair value* under IFRS) - **Control premium** (the per share price of the controlling interest shares may be higher than the per share price of the NCI shares). This may be incorporated into the fair value where the market participants assume this would be the case.

Standard/Transaction	**Unit of account** The single asset or liability to be measured (This is an **accounting concept** meaning that this is the way the item appears in the accounting records)	**Unit of valuation/Valuation premise** Highest and best use is in combination with another asset or liability (or group of assets and liabilities)