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JUNE 2014 ASSESSMENT

COURSE: M.COM (INTERNATIONAL ACCOUNTING)

INF. 0318

PAPER: SPECIALISED APPLICATIONS OF GAAP

MARKS: 200

TIME: 4 HOURS

ASSESSOR: PROF D. COETSEE

MODERATOR: MRS E. DU TOIT

1. This paper consists of 8 pages (including the cover page).
2. All the questions should be answered.
3. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and the required depth of the answer.
5. Answer the questions using:
 - effective arrangement and presentation;
 - clarity of explanations;
 - logical argument; and
 - clear and concise language.
6. This is an open book assessment.

QUESTION 1

(30 MARKS)
(36 MINUTES)

In a feedback statement the IASB made the following comments regarding the two-measurement-category approach in IFRS 9 *Financial Instruments: Recognition and Measurement*:

One of the most common criticisms of IAS 39 is that it is complex because it has too many classification categories for financial instruments - each with its own rules for determining which instruments must, or can be, included and how the assets are tested for impairment.

In the light of what we learned from responses to our discussion paper and our extensive consultations, we concluded that financial statements that differentiated between:

- financial instruments that have highly variable cash flows or are part of a trading operation; and
- financial instruments with principal amounts that are held for collection or payment of contractual cash flows rather than for sale or settlement with a third party

would provide users of financial statements with more useful information than they were receiving from the application of IAS 39.

We therefore proposed classification and measurement on the basis of how an entity manages its financial instruments (its business model) and the contractual cash flow characteristics of the financial instruments. Our objective was to measure, on the basis of this classification, at fair value those instruments for which current values are more informative and at amortised cost those instruments for which contractual flows are more informative.

Required

Discuss whether you agree that the two-measurement-category approach included in IFRS 9 would provide more useful information. Your solution must include a discussion of the appropriateness of using a business model for financial reporting purposes and the appropriateness of including exceptions to the two-measurement-categories approach.

QUESTION 2

(45 MARKS)
(54 MINUTES)

In an internet publication *The big one: The IASB's exposure draft on expected credit losses* John Hughes states the following:

In particular, the proposals distinguish between instruments that have and haven't deteriorated significantly in credit quality since inception. Assuming it has low credit risk at the reporting date, an instrument without such deterioration is treated by recognizing an estimate only for "12-month expected credit losses" (the lifetime cash shortfalls that will result if a default occurs *in the twelve months after the reporting date*, weighted by the probability of that default occurring), rather than for credit losses expected over its lifetime. Once the instrument exhibits such deterioration, but assuming there's still no objective evidence of an *actual* loss event, then the estimate expands to encompass expected *lifetime* losses. In each of these cases though, interest revenue continues to be calculated on the asset's *gross* carrying amount (that is, without being reduced for the estimates of losses). After the instrument becomes subject to objective evidence of impairment, then the entity switches to recognizing interest revenue on the *net* carrying amount.

As illustrated, this differs from the way the IASB came at it in its 2009 Exposure Draft, which proposed adjusting the effective interest rate from the outset for initial expectations of lifetime credit losses, so that the carrying amount of a financial asset measured at amortized cost would always equal the present value of the expected future cash flows, discounted at the credit-adjusted effective interest rate.

"The IASB doesn't really seem to have moved away from this original vision, but it's been persuaded about the extent of the "operational challenges" it represented. As it now puts it, the new approach: "would achieve an appropriate balance between the benefits of a faithful representation of expected credit losses and the operational costs and complexity. The IASB acknowledges that this is an operational simplification and that there is no conceptual justification for the 12-month time horizon". In fact, it even acknowledges that the new proposal "would result in an overstatement of expected credit losses for financial instruments, and a resulting understatement of the value of any related financial asset, both at and immediately after initial recognition of those financial instruments." On this basis, IASB member Stephen Cooper voted against the exposure draft, unwilling to sign on to something that seems out of step with the IASB's own conceptual framework, and in any event believing the 2009 proposals wouldn't actually have created significantly more operational challenges than the new proposals.

Well, there's no doubt the perfect is the enemy of the good, and while it's obvious the new proposals aren't perfect, it's harder to assess what net benefit they might represent. Given the disagreement cited above on the real-world impact of financial reporting this area, maybe we'll *never* know that. I just wish it felt like an approach that would stand the test of time...

Required

Discuss whether the new 3 stage approach of determining expected credit losses would create an appropriate balance between the benefits of a faithful representation of expected credit losses and the operational cost and complexity. Your solution must include a discussion of whether you agree with the proposals identifying when interest revenue should be calculated on the gross carrying amount or the net carrying amount as well as your opinion on the proposals to use credited-adjusted effective interest rates for discounting purposes.

QUESTION 3

(40 MARKS)
(48 MINUTES)

In a *Snapshot: Review of the Conceptual Framework* the IASB made the following comments regarding different classes of equity and the distinction between equity and liabilities:

Different classes of Equity

Financial statements do not typically provide enough information about the claims of different classes of equity investors, such as the effect of senior equity claims on subordinate equity claims.

The Discussion Paper suggests that entities should use an enhanced statement of changes in equity to provide more information about different classes of equity.

An enhanced statement of changes in equity would provide more information about the different classes of equity claims and show how wealth is transferred between those classes. It might also enable the IASB to simplify the IFRSs that distinguish liabilities from equity instruments.

Distinction between equity and liabilities

Existing IFRSs do not apply the definition of a liability consistently when distinguishing liabilities from equity instruments. The resulting requirements can be complex, difficult to understand and difficult to apply.

The Discussion Paper does not propose to change the existing definition of equity. To distinguish between equity instruments and liabilities, the IASB would use the existing definition of a liability, which focuses on whether the entity has an obligation to deliver economic resources.

Required:

- (a) Discuss whether you agree with the proposals to transfer wealth between different classes of equity.
(25)
- (b) Discuss why existing IFRSs do not apply the definition of a liability consistently when distinguishing liabilities from equity instruments.
(15)

QUESTION 4

(40 MARKS)
(48 MINUTES)

In the article IFRS 13 *Fair Value Measurement: What does this mean for valuation?* summarised IFRS 13 as follows:

IFRS13 provides a single source of guidance for all fair value measurements, clarifying the definition of *fair value* and enhancing disclosures about reported fair value estimates. Historically, fair value guidance was spread across various standards and it was incomplete in certain places, while silent in other situations. This created the potential for inconsistency and differences in interpretation when arriving at an estimate of fair value. In providing a single source of guidance and a precise definition of fair value, the standard will (i) assist in improving consistency and comparability, (ii) help preparers and auditors in fulfilling their role, and (iii) contribute to users' understanding of what fair value represents. A key point to highlight is that the standard addresses *how* to measure fair value, not *when* to measure it. In practice, this means we do not expect an increase in items reported at fair value, but the newly introduced framework may result in changes to *how* fair value has been historically measured and disclosed.

Required

Discuss whether IFRS 13 *Fair Value Measurement* creates an appropriate framework for the measurement of fair value. In your discussion you need to identify practical issues with the application of IFRS 13, if any.

QUESTION 5

**(45 MARKS)
(54 MINUTES)**

In a Harvard Business School publication on *The Landscape of Integrated Reporting: Reflections and Next Steps* Robert Eccles makes the following comments in his introduction *The State of Integrated Reporting Today*:

In a very real sense, the question of the role of corporations in society and the content and practice of integrated reporting are inseparable. A company's reporting practices are a representation of how it sees itself and, in turn, they shape what it will become. Rethinking the role of the modern corporation and developing integrated reporting frameworks and practices will reinforce each other.

The purpose of external financial reporting is to help investors make investment decisions. Similarly, the original purpose of nonfinancial reporting (also called corporate social responsibility or sustainability reporting) was to provide information of interest to other stakeholders. Investors, especially socially responsible investors (SRIs) and some of the large pension funds that have a long-term view, are becoming increasingly interested in nonfinancial information. A company's performance on environmental, social and governance (ESG) issues affects how well it is managing risk in the short term and contributes to its performance over the long term. However, just how much attention investors pay to nonfinancial information when making their decisions is a topic of much debate today and the answer varies according to geographical location (e.g., more in Europe than in the U.S. and Asia) and investment strategy (e.g., more by SRIs and pension funds than by hedge funds and mutual funds).

The challenges of making sure that there is a well-defined and common conception of integrated reporting; establishing frameworks, measurement and reporting standards; developing the necessary audit methodologies; and learning how to leverage technology and effectively engage with all stakeholders are immense. An even greater challenge is creating and implementing a collaborative action strategy for the rapid and broad adoption of integrated reporting around the world in order to ensure a sustainable society.

Three clear points emerge on developing and implementing an action strategy. The first is a clear sense of urgency – we have 10 years at most to make integrated reporting the universal practice. The second is that both market and regulatory forces must be brought to bear. The third is that collaboration on a massive scale with virtually every stakeholder group will be required.

I have a final reflection of my own. The most important thing about integrated reporting today is that it is an emerging social movement. The meaning of integrated reporting will only be developed and its implementation will only happen if this movement is an effective one. This will require a high level of commitment that comes from energy, enthusiasm, trust, courage, persistence and collaboration amongst every person and

Organization who believes that integrated reporting can play an important role in ensuring that we have a sustainable society.

Required

Discuss whether you agree that the International <IR> Framework developed by the International Integrated Reporting Council creates an appropriate Framework for the preparation of integrated reports and whether the International <IR> Framework will resolve the issues identified by Robert Eccles.

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